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MASTER LIMITED PARTNERSHIPS

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

JULY 21, 1987

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MASTER LIMITED PARTNERSHIPS

TUESDAY, JULY 21, 1987

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Max Baucus (subcommittee chairman) presiding.

Present: Senators Baucus, Matsunaga, Bradley, Danforth, Chafee, Heinz, and Wallop.

[The press release announcing the hearing and an explanation on the taxation of master limited partnerships by the Joint Committee on Taxation follows:]

[Press Release #H-54, June 30, 1987]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT TO HOLD HEARING ON MASTER LIMITED PARTNERSHIPS

WASHINGTON, DC.—Senator Max Baucus (D., Montana), Chairman of the Senate Finance Subcommittee on Taxation and Debt Management, announced today that the subcommittee will hold a hearing on the taxation of widely held limited partnerships, also known as master limited partnerships.

The hearing is scheduled for Tuesday, July 21, 1987 at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"The subcommittee will examine the impact, if any, of the use of master limited partnerships on the corporate income tax base," Senator Baucus stated. "The subcommittee will consider this issue in the broad context of the corporate tax system generally and the effects of the Tax Reform Act of 1986 on businesses' choice of form."

TAXATION OF MASTER LIMITED PARTNERSHIPS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE
ON JULY 21, 1987

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on July 21, 1987, on the tax treatment of master limited partnerships (also referred to as "MLPs.").

In its press release on the hearings dated June 30, 1987, the Subcommittee stated that the hearing would examine the impact, if any, of the use of master limited partnerships on the corporate income tax base. The Subcommittee also stated that it would consider this issue in the broad context of the corporate tax system generally and the effects of the Tax Reform Act of 1986 on businesses' choice of form of doing business.

This pamphlet,[1] prepared in connection with the Subcommittee hearing by the staff of the Joint Committee on Taxation, provides a description of present-law tax treatment of master limited partnerships and an analysis of the tax issues. Part I is an overview. Part II is a description of present law relating to the tax treatment of partnerships, S corporations, trusts, and other passthrough entities; the tax treatment of corporations and their shareholders; and master limited partnerships and the types of transactions by which MLPs are typically formed. Part III of the pamphlet contains an analysis of the Federal tax issues concerning tax treatment of master limited partnerships and other partnership tax issues.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Taxation of Master Limited Partnerships* (JCS-19-87), July 20, 1987.

I. OVERVIEW

Present law

For a number of business or other reasons, owners of a business or of income producing property may prefer to conduct the business or hold the assets in a separate entity. The tax consequences of using a separate entity depend on the type of entity that is used. Under present law, several types of entities may be treated for tax purposes as passthrough entities: i.e., entities that generally do not pay income tax themselves, but whose owners are subject to tax on income earned by the entity.

Some types of entities are treated principally as conduits, in that income and loss of the entity is normally taken into account directly by the owners. Examples of this generic type of passthrough entity are partnerships and S corporations. Other types of entities are not treated as pure conduits, in that losses are not passed through, but net income or distributions generally are subject to one owner-level tax rather than to tax at both the owner and the entity level. Examples include real estate investment trusts and regulated investment companies. Some trusts can also be characterized as, in effect, conduits; although a trust is generally taxed as a separate entity, it may deduct distributions to beneficiaries, who generally include the distributed amounts in their income. Grantor trusts are taxed as if the property held by the trust were still retained by the grantor.

By contrast, C corporations are not treated as conduits for tax purposes. Income or loss of a C corporation is taken into account for tax purposes at the corporation level, and determines the corporation's tax liability. Distributions by corporations to their shareholders are separately subject to tax in the hands of the shareholders in determining their own tax liability. Income of C corporations is thus said to be subject to two levels of tax: once at the corporate level when earned by the corporation, and again at the shareholder level when the corporation makes distributions to them.

Present law sets forth criteria applicable in distinguishing among types of entities that receive passthrough tax treatment, and in distinguishing such passthrough entities from C corporations. In general, applicable Treasury regulations provide factors for distinguishing among partnerships, corporations and trusts. In addition, special rules apply to certain types of passthrough entities, including S corporations, real estate investment trusts, regulated investment companies, real estate mortgage investment conduits, cooperatives, and housing cooperatives.

Among the entities that have been considered as partnerships under present law entity classification rules are those known as "master-limited partnerships", or "MLPs." The term refers to the two-tier structure of the partnership, and is commonly used to refer to limited partnerships that are publicly traded, for example, on securities exchanges (like corporate stock and securities), such as the New York Stock Exchange or the American Stock Exchange, or over-the-counter (e.g., through the National Association of Securities Dealers Automated Quotations ("NASDAQ"). This structure might also be used for other partnerships.[2]

Background

The phenomenon of master limited partnerships has attracted increasing attention.[3] Commentators have documented substantial growth in the number of master limited partnerships;[4] and some have asked whether MLPs (and other alternatives to corporate structure) might lead to the "disincorporation" of America.[5] At the same time, MLPs have been discussed as a creative new technique for investment.[6] The first master limited partnership was formed and sold to the public in 1981.[7]

Sales of new equity MLPs have accelerated since enactment of the Tax Reform Act of 1986: New equity (i.e., excluding rollups and liquidations) MLP sales were $1.751 billion in the first 5 months of 1987, 245 percent higher than during the same period in 1986.[8] As shown in Table 1, new equity MLPs increased from 18.8 percent of publicly offered limited partnership sales in 1986 to over 40 percent in the first 5 months of 1987. The ratio of new equity MLP sales to common stock offerings was 7.9 percent, as shown in Table 1.

---

[2] The limited partnership laws of many states require filing a certificate of limited partnership that includes the names of all limited partners. If the ultimate interests in a partnership may trade frequently, a "Master" partnership can be organized in a State that does not require such a filing and interests in it may be offered to the public. The "master" partnership may then be the sole limited partner of a partnership conducting business in a state with the requirement. If the state requires that the names of the limited partners of the "master" partnership be filed, such filing may generally be made only periodically (e.g., monthly).

[3] See, e.g., "Oppenheimer Plans to Sell 30% Stake in Money Management Unit to Public," *The Wall Street Journal* (June 4, 1987) Sheppard, "Taxing Publicly Traded Limited Partnerships as Corporations," *Tax Notes* (April 6, 1987); Chambers and Lyman, "The True Facts About Publicly Traded Limited Partnerships," *Tax Notes* (May 18, 1987), "Some Master Limited Partnerships Offer High Yields but Post Poor Total Returns," *The Wall Street Journal* (March 19, 1987); "Real Estate: Master Limited Partnerships Expected to Flourish Due to Tax Bill," *BNA Daily Tax Report* No. 204 (October 22, 1986); "After Tax Law: A Surge in Sales of Partnerships," *The Wall Street Journal*, (June 11, 1982); "A New Financing Tool is in Trouble Already," *Business Week* (June 29, 1987).

[4] *Public Partnership Sales Update,* The Stanger Report (June 1987).

[5] " America Disincorporated?" *Forbes* (June 16, 1986); "Tax Reform's Tax Dodge," *Forbes* (October 20, 1986); Freeman, "Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of General Utilities," *Taxes* (December 1986).

[6] Lyman, "An Overview of the Origin and Tax Treatment of Publicly Traded (Master) Limited Partnerships," 13 *Tax Management Washington Tax Review* 113 (June 1987).

[7] Apache Petroleum Company (initial offering, January 23, 1981).

[8] Robert A. Stanger & Co. unpublished data.

Table 1.—Limited Partnership, MLP, and Common Stock Sales

[Dollar amounts in millions]

Year	Public Sales of LPs [1]	Sales of new Equity MLPs [2]	Ratio of new Equity MLPs to Total Public LP sales	Total MLP Offerings [3]	Gross Proceeds Primary Public Offerings of common stock [4]	Ratio of new Equity MLP sales to common stock offerings
1981	$4,884	NA	NA	$698	$14,238	NA
1982	$5,510	NA	NA	$724	$13,298	NA
1983	$8,347	NA	NA	$731	$29,525	NA
1984	$8,401	NA	NA	$358	$8,669	NA
1985	$11,549	NA	NA	$5,530	$18,348	NA
1986	$13,138	$2,475	18.8%	$4,097	$31,323	7.90%
May 1987	$4,265	$1,751	41.1%	NA	NA	NA
Growth rate: 1981–86	21.9%	NA	NA	42.5%	17.1%	NA

---

[1] Sales of SEC registered limited partnerships; 1981 is estimated. Source: Robert A. Stanger & Co.

[2] Source: Robert A. Stanger & Co. (new equity MLPs exclude rollups and liquidations).

[3] Source: U.S. Dept. of Treasury, Office of Tax Analysis. Based on data contained in prospectuses and related information. All units offered to the public are not necessarily sold.

[4] Source: U.S. Securities and Exchange Commission, SEC Monthly Statistical Review, Table M-375.

II. PRESENT LAW AND BACKGROUND

The first section of Part II provides a brief description of the tax treatment, including entity classification rules where applicable, of partnerships and various other types of entities that are conduits or whose income is ordinarily subject to tax at the owner level rather than the entity level. Next is a brief description of the tax treatment of C corporations (i.e., those governed by Subchapter C of the Code), with a comparison of corporate and partnership tax treatment. The last section in this part is a description of the tax treatment of typical transactions in which master limited partnerships are formed and operated.

A. Passthrough Entities

1. Partnerships

In general

A partnership is not itself subject to Federal income taxation under present law, but rather, each partner takes into income his distributive share of the partnership's taxable income and the separately computed items of income, gain, loss, deduction or credit of the partnership (sec. 702(a)). The liability for Federal income tax payment is that of the partner, and not of the partnership (sec. 701).

Contributions of property to a partnership, in exchange for an interest in the partnership, generally do not give rise to recognition of gain or loss to the contributing partner or to the partnership (sec. 721).

Distributions from a partnership to a partner (other than in liquidation) generally also do not give rise to recognition of gain or loss to the distributee partner or to the partnership. A partner's basis in his interest is reduced by the amount of money and the basis of property distributed to him (sec. 733). Distributions of money in excess of the partner's basis for his partnership interest, however, do give rise to gain to the partner (sec. 731).

Payments in liquidation of a retiring or deceased partner's interest (that are not treated as a distributive share of partnership income or a guaranteed payment) are generally treated as distributions (sec. 736). The basis to a partner of property distributed in liquidation of his interest is equal to his basis in his interest, reduced by any money distributed in the same transaction (sec. 731(b)). A partner receiving property or money in exchange for all or part of his interest in the partnership must include in income his share of the partnership's unrealized receivables (which includes recapture and similar items) and his share of substantially appreciated inventory items (sec. 751).

Although current distributions to partners are generally not taxable to them, each partner includes in income his distributive share of partnership taxable income, whether or not he receives any corresponding distribution. A partner also takes account, in calculating his income, of separately computed items of partnership income, gain, loss, deduction or credit (sec. 702). This treatment reflects the conduit nature of partnerships.

A partnership may make an election under which each transferee of a partnership interest may step-up the basis of his share of partnership assets to reflect the purchase price paid for the partnership interest (secs. 754 and 743).

The foregoing treatment applies in the case of limited partnerships as well as general partnerships.

Partnership liabilities

In general, at the inception of the partnership, a partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. His basis is generally increased by an increase in his share of liabilities and decreased by a decrease in his share of them (among other factors that affect his basis) (sec. 752). A general partner's liability for his share of the partnership's liabilities is theoretically unlimited and so, as provided in Treasury regulations, a general partner's basis in his partnership interest is increased by partnership liabilities in accordance with his ratio for sharing losses under the partnership agreement (Treas. Reg. sec. 1.752-1).

A limited partner's share of partnership recourse liabilities, under the Treasury regulations, may not exceed the amount that the limited partner may be called upon to contribute under the partnership agreement. However, the regulations provide, with respect to partnership nonrecourse liabilities, that "where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits." Under this provision, a limited partner may increase his basis in his partnership interest by amounts of nonrecourse liabilities for which he has no payment obligation, and which could only affect him indirectly where the cost of debt service reduces his share of partnership taxable income, or the encumbered asset is claimed by the creditor (with no change in the net worth of the partnership).

A related rule provides a partner's distributive share of partnership loss for a taxable year is deductible only to the extent of his basis in his partnership interest (sec. 704(d)). The inclusion of partnership nonrecourse liabilities in a limited partner's basis for his partnership interest in effect increases the amount of partnership losses he can deduct for the year, although he may not have any obligation to pay the liability. The limitation of losses to the amount of the partner's basis may, in some cases, have little practical application if the partner is subject to other limitations on the deductibility of such partnership losses, such as the passive loss rule (which provides that losses from limited partnership interests are treated as passive and are limited to the amount of the taxpayer's passive income for the year (sec. 469)). The passive loss rule does not, however, apply to partners that are widely held corporations. Similarly, the at-risk rule, which generally limits deductions from an activity to the amount the taxpayer has at risk in the activity, does not apply to widely held corporations (sec. 465). Thus, the inclusion of partnership liabilities in a widely held corporate partner's basis in its partnership interest can permit such a partner to increase the amount of partnership losses it may apply to offset unrelated income.

Special allocations

Partners (limited and general) are subject to tax on their distributive shares of the partnership's taxable income or loss, and the partnership's separately computed items of income, gain, loss, deduction or credit (sec. 702). In general, if the partnership agreement does not provide as to the partner's distributive share, then his distributive share is determined in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances (sec. 704(b)).

Partnership income, gain, loss, deduction or credit (or items thereof) may be allocated under the partnership agreement among the partners in a manner that is disproportionate to the capital contributions of the partners. These arrangements are sometimes referred to as "special allocations" and, with respect to any taxable year, may be made by amendment to the partnership agreement at any time up to the initial due date of the partnership tax return for that year (sec. 761(c)), except to the extent such allocations constitute retroactive allocations (sec. 706). If a partnership allocation does not have substantial economic effect, then the partner's share is redetermined in accordance with his interest in the partnership (sec. 704(b)(2)).

Treasury regulations describing when an allocation has substantial economic effect provide generally that to have economic effect, an allocation must be consistent with the underlying economic arrangement of the partners, and for the economic effect to be substantial, there must be a reasonable possibility that the allocation will affect the dollar amounts received by the partners, independent of tax consequences (Treas. Reg. 1.704-1(b)(2)(ii) and (iii)). Allocation of deductions attributable to nonrecourse debt, for which no partner is personally liable, is permitted (provided, *inter alia,* that the partnership agreement provides for a chargeback to the partner of the minimum gain attributable to the allocation based on the nonrecourse debt), even though, as the regulations state, such allocations cannot have economic effect (Treas. Reg. sec. 1.704-1(b)(4)(iv)(a) and (e)).

In general, principal and interest payments with respect to debt of the partnership are not treated as allocations of partnership income. Similarly, payments by the partnership as fees or compensation for services generally are not treated as allocations of income of the partnership. Rather, to the extent that such expenditures are deductible (e.g., interest, or fees that constitute ordinary and necessary business expenses), the deductions reduce partnership taxable income, and could be specially allocated under the partnership agreement (provided that the allocation of the deductions meets the criteria for having substantial economic effect).

Entity classification

The Supreme Court articulated standards applicable in determining whether an entity should be taxed as a corporation in the case of *Morrissey* v. *Commissioner,* 296 U.S. 344 (1935). The court reasoned that the entity in that case resembled a corporation. Thus, the *Morrissey* case is said to have set forth the "resemblance" test referred to in the Treasury regulations regarding entity classification. These regulations govern classification under present law.

In distinguishing partnerships from corporations for Federal income tax purposes, Treasury regulations provide that whether a business entity is taxed as a corporation depends on which form of enterprise the entity "more nearly" resembles (Treas. Reg. sec. 301.7701-2(a)). The regulations list six corporate characteristics, two of which are common to corporations and partnerships: the presence of associates and an objective to carry on business and divide the gains therefrom. Whether an entity is to be classified as a partnership or a corporation depends on whether the entity has more than two of the remaining four principal corporate characteristics. The effect of the regulations generally is to classify an entity as a partnership if it lacks any two of them, without further inquiry as to how strong or weak a particular characteristic is or how the evaluation of the factors might affect overall resemblance (Treas. Reg. secs. 301.7701-2 and -3; *Larson* v. *Commissioner,* 66 T.C. 159 (1976), acq. 1979-1 C.B. 1).

These regulations, known as the "Kintner" regulations, were adopted in 1960 in response to the decision in *U.S.* v. *Kintner,* 216 F.2d 418 (9th Cir. 1954). In that case, a physician successfully sought to have his business association classified as a corporation rather than a partnership under the regulations, to take advantage of the more favorable pension plan rules applicable to corporations (as compared to partnerships) under the law in effect at that time. The regulations were revised in 1960 in response to the decision, to make it more likely that an association would be classified as a partnership and not a corporation.

The Tax Equity and Fiscal Responsibility Act of 1982 changed the favorable pension plan treatment of shareholders who are also corporate employees (as compared, for example, to partners). Thus, the original reason for changing the partnership classification regulations as they were changed in 1960 was removed.

In 1976, the Tax Court suggested that the regulations might not be operating effectively to identify those entities that had an overall corporate resemblance; however, the court concluded it was required to follow the regulations and held that a particular entity was classified as a partnership. *Larson* v. *Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1. A proposed revision of the regulations was issued in January, 1977 (42 Fed. Reg. 1038, January 5, 1977) but was withdrawn almost immediately (42 Fed. Reg. 1489, January 7, 1977).

In applying the existing regulations, the four corporate characteristics are: (1) continuity of life, (2) centralization of management,

(3) liability for corporate debts limited to corporate property, and (4) free transferability of interests (Treas. Reg. sec. 301.7701-2).

An organization is treated as having continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization. In the case of a limited partnership, if the retirement, death or insanity of a general partner causes a dissolution unless the remaining general partners (or all the remaining members) agree to continue the partnership, continuity of life does not exist. The regulations provide that a general or limited partnership subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act generally lacks continuity of life. Under these rules, continuity of life generally does not exist even if the remaining partners have agreed to continue the partnership.

An organization generally has centralized management, under the regulations, if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. A general partnership subject to a statute corresponding to the Uniform Partnership Act generally cannot achieve centralization of management because of the mutual agency relationship between the partners. A limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act generally does not have centralized management unless substantially all the interests in the partnership are owned by the limited partners. However, if all or a specified group of the limited partners may remove a general partner (even with a substantially restricted right of removal), the test for whether there is centralized management is to be based on all the facts and circumstances.

An organization is treated under the regulations as having limited liability if, under local law, there is no member who is personally liable for the debts of, or claims against, the organization. In the case of an organization subject to a statute corresponding to the Uniform Partnership Act (or the Uniform Limited Partnership Act), personal liability generally exists with respect to each general partner. In the case of a limited partnership, however, personal liability does not exist with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization, and when he is merely a "dummy" acting as the agent of the limited partners.

The Internal Revenue Service has taken the ruling position that a corporate general partner in a limited partnership does not have a substantial assets unless, in the case of a partnership with total contributions of less than $2,500,000, its net worth is greater than or equal to the lesser of $250,000 or 15 percent of the total contributions to the partnership, or in the case of a partnership with total contributions of $2,500,000 or more, its net worth is at least 10 percent of the total contributions to the partnership (Rev. Proc. 72-13, 1972-1 C.B. 735). If it meets these tests, however, it will be considered to have substantial assets, and the entity thus will be considered not to have limited liability, for advance ruling purposes. Taxpayers have successfully contended that there is no limited liability under the regulations if the corporate general partner is not a "dummy" acting as the agent of the limited partners (see *Larson v. Commissioner, supra*).

An organization is treated as having free transferability of interests, under the regulations, if members owning substantially all the interests have the power, without the consent of other members, to substitute another person as a member and to confer upon his substitute all the attributes of his interest. Although the regulations indicate, in an example, that free transferability does not exist where unanimous consent of the general partners is required for the assignee of a limited partner's interest to become a substitute limited partner, the *Larson* case (*supra*) found free transferability where the consent of the general partner to substitute limited partners could not be unreasonably withheld.

If an association has no more than two of these four corporate characteristics (in addition to the two factors that corporations and partnerships have in common), then under the regulations, it is treated as a partnership rather than a corporation for Federal income tax purposes.

2. S corporations

In general

Present law provides that S corporations (i.e., those corporations that meet the requirements imposed under Subchapter S of the Code and that elect S corporation status) are generally treated as conduits. Taxable income or loss of an S corporation generally is subject to a single shareholder level tax. Subchapter S was enacted in 1958 to minimize the effect of Federal income tax considerations on the choice of form of business organization, by permitting the incorporation and operation of certain businesses without the incidence of the corporate level tax.[9] Substantial simplifying changes to the provisions of Subchapter S were enacted in the Subchapter S Revision Act of 1982.[10]

Significant differences remain between S corporations and partnerships, however; for example, corporate liabilities are not included in a shareholder's basis for his interest in the corporation, and special allocations are not a feature of S corporations. A transferee of an S corporation interest is not entitled to "step-up" the basis of his share of the entity's assets to reflect his purchase price. The issue of entity classification is not important in obtaining passthrough tax treatment for an S corporation, because only corporations can receive S corporation treatment, and any eligible corporation (generally, one meeting the requirements described below) may simply elect to be subject to the provisions of Subchapter S.

Requirements for S corporations

Under present law, to be eligible to elect S corporation status, a corporation may not have more than 35 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), estates and certain trusts are permitted as shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than half the stock (sec. 1362). Despite these limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the size of such a corporation.

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[9] *See* S. Rept. No. 1983, 85th Cong., 2d Sess., 87 (1958).

[10] *See* S. Rept. No. 97-640, 97th Cong., 2d Sess., 6 (1982).

There is no requirement that an S corporation be engaged in an active business. Excess passive investment income can, however, cause the automatic termination of S corporation status in some circumstances if an S corporation was previously a C corporation and still has C corporation earnings and profits. In such a case, if the S corporation has passive income amounting to more than 25 percent of its gross receipts for 3 consecutive years, the corporation loses its S corporation status (sec. 1362(d)). This rule is intended to prevent a regular C corporation from electing S status and converting, essentially, into a holding company, rather than liquidating and incurring tax at the shareholder level on liquidation proceeds from the period of operation as a C corporation.

S corporations generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the corporate level (secs. 1363 and 1366). Items of income (including tax-exempt income), loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders. A shareholder's deduction for corporate losses is limited to the amount of the shareholder's adjusted basis in his stock and in the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, it generally is carried forward to the next year. The shareholder's basis in his stock and debt is reduced by his share of losses allowed as a deduction and, in the case of stock, by distributions, and the shareholder's basis in his stock is increased by his share of the corporation's income (sec. 1367).

In general, a shareholder is not subject to tax on distributions unless they exceed the shareholder's basis in his stock of the corporation or, in general, unless the corporation was formerly a C corporation and has remaining earnings and profits (sec. 1368). To the extent of such earnings and profits, corporate distributions are treated like dividends of C corporations and generally are subject to tax in the hands of the shareholders.

There are two principal exceptions to the general passthrough treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences.

First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if (for less than 3 consecutive years) the corporation has subchapter C earnings and profits, and has gross receipts more than 25 percent of which are passive investment income for the year (sec. 1375).

Second, present law (as modified by the 1986 Act) also provides that a corporate-level tax is imposed on certain gain of an S corporation that was formerly a C corporation. The corporate-level tax applies to any gain that arose prior to the conversion of the corporation to S status ("built-in gain") and is recognized by the S corporation, through sale, distribution or other disposition within ten years after the date on which the S election took effect (sec. 1374). The total amount of gain subject to corporate-level tax, however, is limited to the aggregate net built-in gain of the corporation at the time of conversion to S corporation status.

3. Trusts

Generally under present law, a trust is taxed as a separate entity. The trust receives a deduction for distributions to beneficiaries, however, and beneficiaries generally include the distributed amounts in income.

Grantor trusts

A grantor trust is not treated as a trust for Federal income tax purposes, but rather the incidence of taxation falls upon the grantor, because the grantor is treated as the owner of the trust (sec. 671). In general, a grantor of a trust is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income, if, as of the inception of that portion of the trust, the value of the reversionary interest exceeds 5 percent of the value of that portion of the trust (sec. 673). The grantor of a trust generally is also treated as the owner if he (or a nonadverse party) has certain powers to control beneficial enjoyment of the corpus or income, or has certain administrative powers over the trust, or has the power to revoke the trust in some circumstances, or may distribute or accumulate the income for the grantor or the grantor's spouse or use the income to pay premiums on insurance on the life of the grantor or the grantor's spouse (secs. 674-677). Thus, in general, if the grantor retains sufficient powers or obtains sufficient current benefits from the trust, he is treated as the owner.

Entity classification of trusts

Treasury regulations provide criteria distinguishing trusts (other than grantor trusts) from partnerships and corporations for tax purposes (Treas. Reg. sec. 301.7701-4). The regulations provide that, in general, the term "trust" refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Under the regulations, an arrangement generally will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore are not associates in a joint enterprise for the conduct of business for profit.

Since the four characteristics discussed above that distinguished partnerships from corporations generally are common to trusts and corporations, the regulations apply the other factors—namely the presence of associates and an objective to carry on business and divide the gains therefrom—in distinguishing a trust from a corporation for Federal income tax purposes (Treas. Reg. sec. 301.7701-2(a)(2)).

Thus, an entity will not be treated as a trust if the trust is used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership (e.g., a Massachusetts business trust) (Treas. Reg. sec. 301.7701-4(b)).

The regulations provide that an investment trust (sometimes also called a "management trust") is generally treated as an association taxable as a corporation, where there is a power under the trust agreement to vary the investment of the certificate holders. Nonetheless, where there is not such a power under the trust agreement (e.g., a fixed investment trust or unit investment trust), the entity will not be treated as a corporation. However, a trust with multiple classes of interests generally is treated as a corporation even if there is no power to vary the investment. (Treas. Reg. sec. 7701-4(c)).

Organizations that are commonly known as liquidating trusts (i.e., organized for the primary purpose of liquidating and distributing the assets transferred to such a trust) and similar organizations generally are treated as trusts (Treas. Reg. sec. 301.7701-4(d)). A liquidating trust is treated as a trust because it is formed with the objective of liquidating particular assets and not for the purpose of carrying on a profit-making business that normally would be conducted through a corporation or partnership. If the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation is lost or abandoned, the organization may no longer be treated as a trust.

4. Other passthrough entities

a. Real estate investment trusts

Under the provisions of the Code applicable to real estate investment trusts (REITs) (secs. 856 *et seq.*), REITs generally are treated as conduits for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary operations.

In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests (except in its first year of REIT status, when fewer than 100 holders are permitted), and would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being, in substantial part, realized from certain real estate and real estate-related sources. Many of the requirements were altered by the Tax Reform Act of 1986 (P.L. 99-514) (the 1986 Act).

The ability of a REIT to engage in regular business activities is limited by several different requirements. First, there is the general requirement that services provided in connection with the rental of real property be rendered through an independent contractor in order for the rent to qualify toward the REIT's income requirement. Certain services may, however, be provided without violating the "independent contractor test." Such services are rent-related services, the provision of which would not result in the receipt of "unrelated business income" by an organization subject to tax on such income. Thus, amounts received by the REIT in connection with the rental of real property would not fail to be treated as rents from real property if the REIT provides only certain services other than services that are considered rendered to the occupant of the property.

Second, there is the imposition of a 100-percent tax (prohibited transaction tax) on gains from the sale of property held for sale to customers in the ordinary course of trade or business (other than foreclosure property). Safe harbors are provided; for example, a REIT may make up to seven such sales under one safe harbor. Under an alternative safe harbor, the REIT may make any number of sales during the taxable year, provided that the adjusted basis of the property sold does not exceed 10 percent of the adjusted basis of all of the REIT's assets at the beginning of the REIT's taxable year.

Third, there is the requirement that income from the sale or other disposition of stock or securities held for less than one year, or real property held less than four years, must account for less than 30 percent of the REIT's income. In addition, income is not treated as being derived from qualified sources if it permits the corporation directly or indirectly to derive profits from an active business.

If a corporation meets these requirements and elects to be treated as a REIT, it generally is subject to the regular corporate tax, but receives a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 95 percent of its ordinary income. The minimum amount that the REIT is required to distribute (i.e., the minimum dividends paid deduction) is reduced by a portion of certain amounts that the REIT is required to include in income in advance of receiving cash. A REIT may receive the dividends paid deduction for a taxable year for dividends paid within a short period following the close of the REIT's taxable year. Nevertheless, certain dividends paid by the REIT following the close of each calendar year may be subject to a nondeductible excise tax of 4 percent to the extent that the REITs income for the calendar year exceeds its distributions for the year by more than a specified de minimis amount. Dividends paid out of the REIT's ordinary income generally are includible as ordinary income to the shareholders.

A REIT that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the REIT pays dividends out of such capital gains, the dividends are deductible by the REIT in computing its tax on capital gains and are taxable as capital gains to the recipient shareholders. For purposes of determining the maximum amount of capital gain dividends that a REIT may pay for a taxable year, the REIT may elect not to offset its net capital gain with the amount of any net operating loss, whether current or carried over from a previous taxable year.

b. Regulated investment companies

Conduit treatment similar to that granted to REITs also is provided to regulated investment companies ("RICs"). In general, a RIC is an electing domestic corporation that either meets, or is excepted from, certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, that has a portfolio of investments that meet certain diversification requirements, that distributes at least 90 percent of its income to its shareholders annually, and that also meets certain other requirements (some of which were modified by the 1986 Act).

The ability of a RIC to engage in an active business is limited by several of these requirements. First, the requirement of registration under the Investment Company Act of 1940 limits the activities that the RIC may engage in. Second, the requirement that most of the RIC's assets must be and most of its income must be derived from stock or securities assures that the RIC cannot engage in any business activities unrelated to investing in stock or securities. This assurance is bolstered by certain diversification requirements, which generally prevent RICs from exercising managerial authority as a result of substantial stock ownership. Permitted income for RICs nevertheless includes foreign currencies and options and futures contracts, derived with respect to the RIC's business of investing.

In addition, the ability of a RIC to actively engage in the business of trading securities is limited by the requirement that less than 30 percent of the gross income of the RIC may be derived from gain on the sale or other disposition of stock or securities, options, futures or forward contracts, or except as provided in regulations, foreign currencies held for less than three months. For purposes of applying this test, any increase in value on a position in a stock or security that is part of certain hedging transactions is offset by any decrease in value (whether or not realized) on any other position that is part of such hedge.

A RIC, like a REIT, generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Rules similar to those applicable for REITs apply to distributions of capital gain dividends and to distributions of amounts after the close of the calendar year.

c. Real estate mortgage investment conduits

In general.—A real estate mortgage investment conduit (REMIC) is an entity created by the 1986 Act. In general, a REMIC is a fixed pool of mortgages with multiple classes of interests held by investors.

In general, if certain statutory requirements are met, the REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests therein, under specified rules. Holders of "regular interests" generally take into income that portion of the income of the REMIC that would be recognized by an accrual method holder of a debt instrument that had the same terms as the particular regular interest. Holders of "residual interests" take into account all of the net income of the REMIC that is not taken into account by the holders of the regular interests. Certain special rules apply with respect to the income taken into account by holders of the residual interests. Present law also prescribes rules relating to the treatment of taxpayers who exchange mortgages for interests in the REMIC and the treatment of disposition of interests in the REMIC.

Entity classification.—The pass-through status of the REMIC applies regardless of whether the REMIC otherwise would be treated as a corporation, partnership, trust, or any other entity. Thus, for example, in the case of a REMIC that would be treated as a partnership if it were not otherwise a REMIC, the provisions of subchapter K of the Code would not be applicable to any transactions involving the REMIC or any of the holders of regular or residual interests.

d. Cooperatives

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code. In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception—the cooperative may compute its taxable income without regard to amounts paid to its patrons as patronage dividends. In general, patronage dividends are amounts that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. This rebate may be in a number of different forms.

In general, a cooperative is permitted to compute its taxable income without regard to patronage dividends only to the extent of net income derived from transactions with its members. Thus, cooperatives generally are subject to corporate tax on profits derived from transactions with nonmembers. In addition, if an entity qualifies as a tax-exempt farmers' cooperative under section 521(b) of the Code, it generally may deduct patronage dividends to the full extent of its net income and also may deduct, to a limited extent, dividends on its common stock.

Members of the cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

e. Cooperative housing corporations

Under present law, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued by the cooperative to the extent that such amounts represent the taxpayer's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative that is paid or incurred by the cooperative with respect to the cooperative's land or buildings, and (2) interest allowable as a deduction to the cooperative that is paid or incurred by the cooperative with respect to indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, rehabilitation, etc., of the cooperative's buildings. Where a cooperative housing corporation charges each tenant-stockholder with a portion of the cooperative's interest or taxes in a manner that reasonably reflects the cost to the cooperative of the interest and taxes attributable to such tenant-stockholder's dwelling unit, then the cooperative may make an election whereby the share of the cooperative's interest and taxes that each tenant-stockholder is permitted to deduct would reflect the amounts that were so separately allocated and charged.

In general, a cooperative housing corporation is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution out of earnings and profits of the cooperative, except on complete or partial liquidation of the cooperative, and (4) 80 percent or more of the gross income for the taxable year of which is derived from tenant-stockholders. A tenant-stockholder generally is any person (not just an individual) owning fully paid up stock in the cooperative corporation, the purchase price of which bears a reasonable relationship to the value of the cooperative's equity in its land and buildings that is attributable to the dwelling unit that the individual is entitled to occupy.

B. Corporations and Shareholders

By contrast to the treatment of partnerships and partners, C corporations and shareholders generally are each separately subject to tax on distributed corporate income. The shareholders do not calculate tax liability by reference to the corporation's income; instead, the corporation pays tax on its income. The shareholders generally include in their income amounts that the corporation distributes to them. Although discussed in more detail below, the principal rationale for imposing a corporate income tax as well as a shareholder-level tax on distributions is that the corporation is a separate entity for business, accounting, and legal purposes, and thus economic reality (as well as concern for administrability of the tax law) dictates that it be subject to tax separately from its shareholders.

In general

Corporations are subject to tax on their taxable income (secs. 11, 1201) or, if greater, to the tax imposed under the corporate alternative minimum tax (sec. 55). Taxable income is generally the taxpayer's gross income less deductions. Net losses of the corporation for a taxable year are not passed through to shareholders, but generally are carried back or forward to offset the corporation's income for other taxable years (sec. 172).

Contributions

Present law provides for tax-free contributions by shareholders to corporations, similar in some respects to tax-free contributions by partners to partnerships, if certain requirements are met. No gain or loss is recognized to the corporation or to the contributing shareholder, in the case of contributions of property to a corporation solely in exchange for stock or securities of the corporation, by one or more persons who have control of the corporation immediately after the exchange (sec. 351). Control is defined for this purpose as ownership of at least 80 percent of the stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock (sec. 368(c)). The control requirement for tax-free contributions by shareholders differs from the treatment under the partnership rules, which do not require that the partner control the partnership for his contribution to be tax-free.

Distributions

Dividend distributions by corporations to shareholders are generally subject to shareholder-level tax (sec. 301). Dividends are generally those amounts representing distributions from the corporation's earnings and profits (secs. 301(c), 316). An exception is provided for distributions of the corporation's stock, which are generally not treated as taxable dividends to the shareholders (sec. 305). Distributions to shareholders with respect to the corporation's stock, in excess of the amount constituting a dividend, are treated as tax-free return of basis to the extent of the shareholder's basis in the stock, and as gain thereafter (sec. 301(c)). Unlike partnership distributions, corporate dividend distributions (other than stock dividends) generally do not affect the shareholder's basis in his stock.

Shareholders are also subject to tax in the case of liquidating distributions by the corporation; the amount received by a shareholder as a liquidating distribution is treated as received in exchange for his stock (sec. 331). Thus, the shareholder includes in income the excess of the amount received in liquidation over his basis for his stock.

The distributing corporation is also subject to tax upon distributions of appreciated property under present law as amended by the 1986 Act, whether the distribution is a liquidating distribution or not (secs. 311, 336). The corporation may recognize a loss upon the distribution of property in liquidation, but not upon the nonliquidating distribution of property with respect to its stock. An exception is provided from the requirement that the corporation recognize gain upon a distribution of property with respect to its stock, in the case of distribution of its stock (or rights to acquire its stock) (sec. 311(a)(1)), which is also generally not treated as income to the shareholder.

Affiliated groups

One structural difference between partnerships and corporations is that an affiliated group of corporations may elect to file a consolidated return, which has the general effect of treating the group as one corporation for purposes of calculating income tax liability (sec. 1501, Treas. Reg. sec. 1.1502-2). In general, an affiliated group of corporations means one or more chains of corporations where the common parent corporation directly owns at least 80 percent (by vote and value) of at least one other corporation in the group, and at least 80 percent (by vote and value) of the stock of each other member of the group is owned directly by one or more of the other corporations permitted to be in the group (sec. 1504(a)). Applicable Treasury regulations provide detailed rules for the administration of this concept, including limitations on the use of loss carryovers of one member of the group to offset income of other members arising in years when they were not members of the group (Treas. Reg. sec. 1.1501-1).

Under the consolidated return regulations, intercompany dividends are eliminated in calculating the tax liability of the group (Treas. Reg. sec. 1.1504-14). This rule has the effect of not imposing shareholder level tax until the income is distributed outside the affiliated group.

In addition, present law provides a dividends received deduction for corporations if they are not members of an affiliated group filing a consolidated return (sec. 243). Dividends received by a corporation from another corporation are fully deductible, if the payor corporation would be treated as an affiliate (as described in the previous paragraph), but no consolidated return election is in effect. If the payor corporation would not be treated as an affiliate, the dividend received is still 80 percent deductible.

Thus, the dividends received deduction and the consolidated return rules generally cause dividend distributions to corporate shareholders to be either tax-free, or taxed at a very low effective rate, until the amounts are distributed outside of corporate solution.

Present law provides no comparable rules for affiliated or commonly owned partnerships; the above result, however, is similar to the treatment of income of tiered partnerships. A partner in the top tier partnership generally includes in income his distributive share of income of the top tier partnership, which would include a share of income of indirectly owned partnerships. No distinction is made among different types of partners (e.g., corporations or individuals).

Entity classification

As discussed in more detail above (see 1. Partnerships, *supra),* Treasury regulations currently in effect provide criteria for distinguishing partnerships for corporations for Federal tax purposes. In general, the regulations provide that if an association has more than two of four listed corporate characteristics, it is classified as a corporation rather than a partnership. The four corporate characteristics are: (1) continuity of life, (2) centralization of management, (3) liability for corporate debts limited to corporate property, and (4) free transferability of interests.

Liabilities; allocations; inside basis

Unlike partnership liabilities, corporate liabilities are not included in the shareholder's basis for his stock. Nor are special allocations to shareholders of corporate income or loss (or items thereof) provided, because corporate income or loss is taxed at the corporate level, not at the shareholder level. The basis of assets held at the corporate level is not stepped up to fair market value when stock changes hands.

C. Master Limited Partnerships

In general

Master limited partnerships are generally thought of as limited partnerships whose limited partnership interests are publicly traded like corporate securities on an exchange or over the counter (for example, on the New York Stock Exchange or through the NASDAQ system). Under applicable Federal securities laws, unless a registration exception applies, such limited partnership interests are normally required to be registered with the Securities and Exchange Commission, and in some cases will also be required to be registered under applicable State securities laws as well. The limited partnership, as an issuer of registration-required securities, generally is required to file annual and quarterly financial reports (Forms 10-K and 10-Q) with the Securities and Exchange Commission.

Large, widely held limited partnerships, or those whose interests are publicly offered or are registered under Federal or State securities laws are not necessarily publicly traded, on an exchange, over the counter, or otherwise. Some commentators use the term publicly traded limited partnerships (rather than "master limited partnerships") to refer specifically to limited partnerships whose interests are publicly traded.[11]

Master limited partnerships have become substantially more numerous in recent years, since the first such partnership whose interests were traded on a stock exchange was formed in 1981.[12] The formation of these types of limited partnerships has followed several patterns. The most common types of formation transactions can be termed: (1) the rollout (or drop-down) type of transaction, (2) the acquisition (or equity buyout) type, (3) the rollup type, and (4) the corporate liquidation type. The most prevalent types appear to be the rollout and the acquisition types. The liquidation type is significantly less advantageous to the liquidating corporation from a tax standpoint, since the 1986 Act has taken effect, because a corporation is now generally subject to tax on appreciated property distributed in liquidation.

In many of the transactions by which MLPs are formed, part of the impetus for the transaction stems from the appeal of the tax savings that can be effected by conducting a business in partnership form (with one level of tax) rather than in corporate form (with two levels of tax). The formation of an MLP often (but not always) involves the transfer to the partnership of corporate assets or a business activity theretofore conducted in corporate form. Interests in publicly traded limited partnerships can be sold to investors in the same manner as corporate stock and, like stock, provide free transferability and limited liability. Such interests can be marketed as producing a better after-tax yield on current cash return than corporate stock because of tax savings. The following is a more detailed discussion of these types of MLP formation transactions, and their variants.

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[11] Lyman, "An Overview of the Origin and Tax Treatment of Publicly Traded (Master) Limited Partnerships," supra note 6.

[12] *Id.*

Formation transactions

Rollout (drop-down) transactions

A rollout is a transaction whereby a corporation rolls out (or drops down, depending on one's preference for terminology) corporate assets to a limited partnership in exchange for an interest in the partnership. The corporation (often referred to as the corporate sponsor) is typically the general partner of the partnership, and may also receive an interest as a limited partner (i.e., limited partnership units). The contribution of assets to the partnership in exchange for a partnership interest is generally treated as a tax-free contribution both to the partnership and to the contributing corporation (sec. 721).[13] The corporation generally receives a basis in its units equal to the basis of the assets transferred to the partnership (sec. 722). The partnership's basis for the contributed assets generally is the same as was their basis in the hands of the contributing corporation (sec. 723). Thus, if the corporation contributes property whose basis is less than its value, the unrealized appreciation will be subject to tax when the partnership disposes of the property in a taxable transaction.[14]

When the property is contributed to the partnership, limited partnership units are distributed to the public. Three principal alternative means of distributing units to the public are available: (1) a primary offering (sale of limited partnership units directly by the partnership to investors, normally using an underwriter); (2) a secondary offering (sale by the corporation of its limited partnership units to the public); and (3) a distribution by the corporation to its shareholders of limited partnership units.

In a primary offering or a secondary offering, investors buying units are not subject to tax upon the distribution. In the case of a distribution of the units by the corporate sponsor to its shareholders, however, the distribution is normally treated as a dividend, and the value of the units is includable in the income of the recipient shareholders (secs. 301(a) and (c)). In the case of the acquisition of partnership units other than by a contribution transaction (e.g., by purchase), the investor's basis in his units is generally their cost (sec. 742).[15]

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[13] The tax-free nature of the transaction could be affected, for example, in cases where the contributed property is encumbered by debt which the partnership pays off, and the payment is treated as an indirect transfer of money to the contributing partner. If the contribution and the indirect transfer, when viewed together, are properly characterized as a sale or exchange of property, then the contributing corporation may be treated as recognizing gain on the transaction (sec. 707(a)(1)(B)).

[14] Such inherent gain (as well as income, loses and deductions) with respect to contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (sec. 704(c)). The total gain, income, loss and deduction allocated in accordance with this rule cannot exceed the amount of gain, income, loss, or deduction realized by or allowable to the partnership (the "ceiling limitation") (Treas. Reg. sec. 1.704-1(c)(2)).

The tax treatment of the sponsoring corporation differs depending on the means by which limited partnership units are transferred to the public. In the case of a primary offering, there are generally no tax consequences to the corporate sponsor.[16] In a secondary offering, however, the corporate sponsor generally must include in income the gain (including income from recapture and unrealized receivables) attributable to its units that are sold to the public (secs. 741, 751). Similarly, in the case of a distribution of limited partnership units to its shareholders, the corporation is subject to tax on the difference between its basis in the distributed units and the fair market value of the units (sec. 311(b)).

Acquisition (equity buyout) transactions

This type of MLP formation transaction frequently involves a corporate sponsor (like the rollout). The primary difference between a rollout-type transaction and an acquisition-type transaction is that in the former, the corporation contributes assets to the partnership, whereas in the latter, the partnership buys the assets from the sponsoring corporation or from unrelated parties. An acquisition-type transaction may be arranged to buy particular assets, or to buy unidentified assets generically (e.g., rental real estate).

Generally, in an acquisition transaction, a limited partnership is formed (with the corporate sponsor, if any, typically serving as general partner), and limited partnership units are sold to the public in a primary offering. The cash raised through the offering of units (plus any additional amounts borrowed by the partnership) are used to acquire assets by the partnership. Because the partnership acquires assets by purchase, generally its basis in the assets will initially be their cost (which presumably equals their fair market value at the time of purchase) (sec. 1011).

Investors buying limited partnership units in the offering generally will also have a cost basis, which should approximate the value of the assets of the corporation.[17]

The corporate sponsor (or other person) who sells assets to the partnership recognizes gain or loss [18] on the sale. This result can be contrasted to the treatment of the corporate sponsor that contributes assets, generally tax-free, in a rollout transaction. Even if (in a rollout) the corporate sponsor sells units at a gain in a secondary offering, the corporation is generally (depending on whether the transfer of debt to the MLP results in income to the corporation) subject to tax only on the gain inherent in the units that it chooses to sell, not on the full gain inherent in the assets transferred to the MLP as in an acquisition-type transaction. This makes the acquisition-type transaction less attractive than a rollout to a corporate sponsor that has substantially appreciated assets that it wishes to transfer to the MLP.

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[15] In the case of a primary offering not involving an underwriter, or involving a best efforts underwriting (where the underwriter is simply the sales agent rather than the initial buyer of the units), the acquisition of the partnership units generally is treated as a contribution governed by sec. 721, and the unit holder's basis is determined under sec. 722 to be the amount of money he contributed (plus the basis of property, if any, that he contributed). The distinction between acquiring units by purchase and by contribution is important principally in determining the unit holder's inside basis for partnership assets. Where a partner acquires an interest in a partnership by purchase, and the partnership has made a "section 754 election," the partner may step up his share of the partnership's basis in its assets to reflect his purchase price (secs. 754 and 743(b)). This can be advantageous to a partner should the partnership sell appreciated assets, for example, and the appreciation in the assets was reflected in the price he paid for his unit. This treatment is not available for partnership units acquired by contribution.

[16] But see note 12, *supra*.

[17] Because partners include partnership-level liabilities in their basis for their partnership units, a limited partner's basis in his unit will generally approximate the cost to the partnership to acquire its assets, even if the partnership borrows (using nonrecourse debt) to acquire them.

[18] If the corporate sponsor has a greater than 50 percent interest in the partnership, no deduction is allowed to the corporation in respect of losses on the sale (sec. 707(b)).

Rollup transactions

In a rollup transaction, existing limited partnerships are "rolled up" and consolidated into one larger partnership. In a rollup, the existing partnerships are treated as contributing their assets to the master limited partnership, in exchange for units of the master limited partnership, and then distributing the units to their partners in liquidation. The master limited partnership thereby owns the assets of the pre-existing partnership, and has as its unit holders the partners of the pre-existing partnerships.

The tax consequences to the pre-existing partnerships (and to their partners) are that they generally do not recognize gain or loss on the contribution (sec. 721). Their basis in the MLP units is the same as their basis for the contributed assets (sec. 722). On the distribution of the units to the partners, the partners generally do not recognize gain or loss (sec. 731), and have a basis in the units equal to their basis in their interests in the pre-existing partnerships (sec. 732(b)).

The master limited partnership generally does not recognize gain or loss on the contribution of assets in exchange for units (sec. 721), and has a basis in the contributed assets equal to the basis of the assets in the hands of the pre-existing partnerships (sec. 723). Unrealized gain or loss in the assets acquired by the MLP is not eliminated.[19] Thus, in general, rollup transactions are likely to be tax-free to the participants in the transaction.

Liquidation transactions

A liquidation transaction for forming an MLP involves the complete liquidation of the corporation whose assets the MLP acquires. In the transaction, the corporation contributes all of its assets to the MLP in exchange for units of the MLP. The corporation then distributes the units to its shareholders in complete liquidation.

The corporation generally recognizes no gain or loss upon the contribution of its assets to the partnership in exchange for partnership units (sec. 721), and its basis in the units is the same as the basis in the transferred assets (sec. 722). Thus, any built-in appreciation in the assets is preserved in the units. Under present law, as amended by the 1986 Act, a corporation recognizes gain on the distribution of appreciated assets in liquidation (sec. 336). In addition, the amount of recapture of tax benefits is subject to corporate tax at ordinary income rates (e.g., sec. 1245). The 1986 Act repeal of the *General Utilities* rule (which provided for nonrecognition of gain by a corporation upon the distribution of property in liquidation) means that a liquidation transaction for forming an MLP is substantially less attractive for a corporation with appreciated assets (unless the corporation has losses sufficient to offset all or a significant part of the liquidation gain).

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[19] But see the discussion of terminations, below.

The tax consequences to the shareholders of the liquidating corporation upon receipt of the MLP units is generally that gain is recognized to the extent the value of the units exceeds their basis in their stock (sec. 331). Consequently, their basis in their units includes the amount of gain recognized upon the distribution (sec. 334(a)), and normally equals the fair market value of the units immediately after the distribution. Thus, in a liquidation transaction, initial cost to the distributee shareholder of acquiring the units is only the tax liability attributable to the distribution, not the full purchase price as in a transaction involving a primary offering.

Operation of the MLP

Several other issues arise in the ongoing operation of a master limited partnership in connection with the fact that its partnership interests are publicly traded. First, partners may have to recognize investment credit recapture, and depreciable partnership assets may become subject to different depreciation rules, among other consequences, if a sufficiently large number of units (i.e., 50 percent or more of the total interests in partnership capital and profits) are sold or exchanged in any 12-month period (sec. 708(b)), causing a termination and re-formation of the partnership for tax purposes. Second, depending on the type of transaction by which the partnership was formed, different limited partnership units may not be treated as fungible, because they have differing tax attributes. In addition, the tax consequences to tax-exempt and foreign investors differ from the consequences to other investors.

Terminations

In general, under present law, a partnership is considered terminated for tax purposes if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits (sec. 708(b)). A tax termination is not necessarily a dissolution of the partnership under applicable State law. Instead, the partnership is deemed for tax purposes to distribute its properties to the partners in proportion to their respective interests in the partnership properties. Immediately thereafter, the partners are deemed to contribute the properties to a new partnership (Treas. Reg. sec. 1.708-1(b)(1)(iv)).

Generally, a termination requires the closing of the partnership books. A termination also triggers recapture of credits, and generally causes depreciable property to be treated as newly placed in service (possibly under a different depreciation scheme, if it was originally placed in service before 1987). Thus, in general, a termination may require partners to include additional amounts in income, and also could cause the inclusion of two taxable years of partnership income in one taxable year of the partner if the partner and the partnership are not using the same taxable year (due to the closing of the books).

A termination of a publicly traded partnership may not be an unlikely event; it could occur, for example, as a result of trading of more than half of the interests in the partnership during a year. It may be difficult to properly apply the termination rule, when publicly traded partnership units are held in street name and it may not be obvious that more than half of the units have changed hands within a year. A termination could also result from an underwriting arrangement for a public offering of partnership units in which the underwriter is treated as the partner, and the purchasing investors are treated as acquiring their units in a sale or exchange.

Fungibility of limited partnership units

If limited partnership units are to be traded in a public market like a stock exchange, over the counter, or the like, it is generally considered important that the traded units, like shares of stocks of the same class, all have the same economic and tax attributes. Units do not automatically have the same tax attributes; for example, where the corporate sponsor contributes property and acquires units in the transaction by which the MLP was formed, tax attributes of the contributed property are allocable to the corporate sponsor's units (sec. 704). Further, the "ceiling rule" (which limits the amounts so allocable to the total such amounts allowable to the partnership) may also apply, if the basis of the property contributed is lower than the amount of each contributed by the other partners. If the ceiling rule applies, the tax attributes that can be allocated in accordance with this rule are limited, creating further distortions in the tax attributes among the units.

As another example, where the initial public investors acquire their units by contribution, any adjustments made to the basis of partnership property to take account of appreciation in value (and increases in trading prices) of the units (sec. 754) apply only to partners who subsequently acquire their units by sale or exchange, not to the original contributing partners. Similarly, if a secondary offering of units (e.g., to raise more cash) subsequently occurs, the newly offered units may also have different tax attributes. Some master limited partnerships have attempted to make curative allocations of partnership items of income or deduction to counteract the tendency towards tax differentiation among traded units.

Treatment of tax-exempt limited partners

Under present law, tax-exempt organizations are generally subject to tax on unrelated business income (sec. 511). Generally, tax-exempt organizations that are limited partners of a master limited partnership are treated as engaged in the business activity of the partnership, and are normally subject to unrelated business income tax on income (including income from debt-financed property) from a partnership.[20] Thus, although such income is in fact subject to only one level of tax (i.e., at the partner level), tax-exempt organizations have been reluctant to acquire partnership interests. In comparison to other possible investments that do not normally generate unrelated business income to such organizations (such as corporate stock), partnership interests have no greater tax benefit to tax-exempt organizations than to taxable investors. A further disincentive for such organizations to invest in partnerships is the possibility that they will have to file State tax returns in jurisdictions where the partnership is doing business.

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[20] An exception to the unrelated business income tax is provided in the case of debt financed real property, provided the property is not leased back to the seller and certain other requirements are met (sec. 514(c)(9)).

Treatment of foreign investors

Nonresident aliens and foreign corporations are generally subject to United States income tax (absent treaty exemptions) at regular rates on income that is effectively connected with the conduct of a United States business (secs. 871(b), 882(a)). Such a foreign person is treated as engaged in a United States trade or business if he is a partner in a partnership engaged in business in the United States (sec. 875). Thus, in general, such foreign persons are subject to United States income tax on business income earned in the business of a partnership in the United States. Further, withholding may be imposed on some types of distributions (secs. 1441, 1442, 1446), and on gains from the disposition of United States real property interests (sec. 1445).

III. ANALYSIS OF TAX ISSUES

A. Master Limited Partnership Issues

Under present law, MLPs can be classified as partnerships because they typically lack at least two of the four "corporate" characteristics as defined in the applicable regulations. For example, they lack "continuity of life" because the partnership is formed under a state law corresponding to the Uniform Limited Partnership Act and they lack "limited liability" under the standards that have been developed for identifying that factor.

The principal issue arising from the tax treatment of master limited partnerships is whether present-law conduit treatment of such entities is appropriate. The most frequently advanced idea for altering the present-law conduit treatment of master limited partnerships is to treat them as C corporations, subjecting their income to two levels of tax (corporate and shareholder). A number of such proposals are described below, along with arguments for and against the proposals.

Reclassifying publicly traded or publicly offered limited partnerships as corporations for tax purposes is not the only possible alternative. For example, some have suggested retaining a one-level tax structure for these entities, while modifying the way it applies to ensure that the tax is collected. For example, it has been suggested that the tax be paid by the owners of the entity on its earnings that are distributed to them, and by the entity on earnings that it retains. It has also been suggested that the present-law conduit treatment not be altered but that instead, withholding at the entity level on income taxed to owners be instituted. Other suggestions to improve compliance and collection have also been made—for example, suggestions to improve information about the identity of the beneficial owners of interests, such as forbidding the holding of interests in "street" name.

Another single-level tax regime that has been suggested is to permit no passthrough of losses, and to require annual distribution of net taxable income of the entity, with collection of the tax on the income at the entity level. Under this regime, the entity would not be permitted to maintain any significant long-term debt, nor would special allocations or partnership elections to step up the basis of assets for purchasing partners (sec. 754 elections) be permitted. Income from this type of entity would be treated as portfolio income under the passive loss rule.

The entity classification issue can be viewed broadly as a question of the appropriateness of one level of taxation on business earnings under the circumstances, as well as involving related questions such as administrability and interrelation with other rules, such as the passive loss rule.

Proposals

Treasury Department

In testimony before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on June 9, 1986, the Treasury Department recommended that publicly traded limited partnerships be subject to tax as corporations. In testimony before the same Subcommittee on June 30, 1987, the Treasury Department again made the same recommendation, suggesting also that Congress consider extending the current statutory pass-through models to include activities such as natural resource development.

In addition, in the November 1984 Treasury Department *Report to the President on Tax Reform for Fairness, Simplicity and Economic Growth* (the "Treasury report"), Treasury proposed treating as corporations those limited partnerships with more than 35 limited partners. The proposal was not included in the May 1985 *President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.*

ALI Subchapter K Project

The American Law Institute Federal Income Tax Project on Subchapter K (1984), at 392, proposes that publicly traded limited partnerships be subject to tax as corporations.

Senate Committee on Finance Staff Report

The Senate Committee on Finance Preliminary Staff Report (October 1983) concerning recommendations for taxation of corporations, also included a recommendation that publicly traded limited partnerships be subject to tax as corporations. The final Staff Report (Senate Committee on Finance, the Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff (May 1985) at 2) does not include the recommendation because of the fact that at the time the final report was published, the 1984 Treasury report had recently been published including the broader 35-limited-partner proposal, and the Staff determined that it would not approach the issue in a piecemeal manner.

Analysis

Corporate level tax system and similarity to corporations

Those who support proposals to change the classification of MLPs argue that publicly traded limited partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners as a practical matter resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity. Consequently, these types of entities and their holders should be treated similarly for tax purposes.

They further argue that, whatever the merits of the present-law system of double taxation of corporate income, Congress has expressly retained it. It is inconsistent and unfair to allow some businesses electively to integrate the corporate and shareholder level taxes, simply by choosing to operate as a master limited partnership rather than a corporation. Similarly situated taxpayers should be treated the same.

Those who oppose taxing master limited partnerships as corporations make several arguments regarding the similarity between such partnerships and corporations. One threshold argument is that the double-level corporate tax system of present law is irrational and creates inefficiencies. Therefore, it should not be expanded beyond its present scope to encompass master limited partnerships as well.

That double taxation of income earned in corporations is theoretically wrong is based on the premise that, ultimately, all income tax liability is borne by individuals, either directly or indirectly in the form of increased costs of goods and services or decreased return on services or capital. It is argued that the two-tier tax on corporate income imposes a greater tax on income earned in corporations and thus is unfair; further, it creates distortions in investment decisions that lead to economic inefficiency.[21] The preferable model would have the effect of taxing an individual owner on his share of corporate income in the year earned, some argue, which is comparable to the way a partnership and its partners are taxed. Thus, current treatment of MLPs represents a theoretically correct result that should not be overturned, just because it is different from the (arguably theoretically incorrect) way that similarly situated corporations and shareholders are taxed.

Some who favor elective integration of the corporate and shareholder levels of tax question the use of publicly traded limited partnerships as the means for accomplishing this goal. They argue that integration is beneficial because it increases the likelihood that investment decisions will be made on economic, not tax factors, i.e., that integration increases the neutrality of the tax system as a theoretical matter. However, they question whether it is desirable to accomplish integration through a system that imposes a tax on investors regardless of whether they have received distributions, as the partnership conduit tax system does. Because the investor in an MLP is taxed currently on his share of partnership income, there may be strong investor pressure to make distributions so that partners will receive the income on which they are paying tax (or at least an amount sufficient to pay the tax currently). Other possible systems of integration could create less pressure for current distributions, and more readily permit the retention of earnings. For example, they suggest that the European gross-up and credit system, or even a dividends-paid deduction system, may be more desirable.

Others argue that elective integration and shareholder levels of tax should not only be permitted, but indeed encouraged through the use of master limited partnerships. Furthermore, elective integration through continued use of master limited partnerships does not have one of the criticized features of some other proposals for integration: it does not give a windfall (in the form of increased stock value) to existing corporate shareholders, who paid a price for their stock that was lower than it otherwise would have been, to take account of the corporate-level as well as shareholder-level tax on earnings on that stock.

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[21] For example, corporations may tend to retain rather than distribute earnings in order to minimize the second-level shareholder tax, or they may incur undesirable levels of debt capitalization because earnings distributed as interest are not taxed at the corporate level.

Another issue is whether it is appropriate to classify a limited partnership as a corporation for tax purposes largely on the basis of public trading. Historically, free transferability of interests has been one of several factors that have been considered important to classification. In 1976, the Tax Court concluded that the existing regulations tend to classify as partnerships entities that might be viewed as bearing a strong similarity to corporations, and effectively invited the Treasury Department to change its regulations, *Larson* v. *Commissioner,* 66 T.C. 158 (1976), acq. 1979-1 C.B. 1. The partnerships involved in that case were not publicly traded, though the court did find that their interests were freely transferable.

Proponents of drawing the line at the point of public trading contend that the types of entities observed to be publicly traded MLPs are virtually indistinguishable from corporations in all their significant aspects, are accessing public capital markets in a manner traditionally performed by corporations, and in addition present unique administrative issues and enforcement concerns if the tax law relating to partnerships is applied to MLPs. In this connection, they also contend that one reason publicly traded limited partnerships present administrative difficulties is that the partnership rules contemplate an entity in which the identity of the investors is known and transfers of interests are easily identifiable. Public trading, they contend, involves a degree of lack of identity of the investor with the entity that particularly justifies separate taxation of the entity, rather than partnership conduit treatment. Accordingly, they conclude that MLPs are particularly appropriate for classification as corporations, regardless of the treatment of other limited partnership entities.

Others contend that a classification standard based on public trading would tend to discriminate against relatively smaller investors who are able to make the minimum investment typically required by an MLP and who seek liquidity. Wealthier investors, who do not seek the same degree of liquidity, can still invest in other partnerships that are not publicly traded and that may require a substantially greater minimum investment than MLPs would require.

Some also contend that other factors (for example, limited liability) may be more significant indicia of corporate similarity than public trading. They contend that MLPs meet the present law standards regarding such factors and that if there is a problem with the present law standards, they should be reexamined generally, not changed solely in the case of MLPs.

Motivations for forming MLPs

Some argue that increased investment in MLPs is principally tax-motivated. They point to changes in the tax law under the Tax Reform Act of 1986 that make conduit entities more attractive as vehicles for business activity than corporations.

For example, under the 1986 Act, the maximum regular corporate tax rate is higher than the maximum individual tax rate. Thus, in addition to the fact that corporate earnings bear a second level of tax when distributed, retained earnings are generally taxed at a higher rate than amounts directly earned by an individual. Furthermore, by increasing the tax rate on capital gains and making that rate generally equivalent to the rate on ordinary income, the Act reduced an investor's incentive to realize income through sales of appreciated stock rather than in the form of current ordinary income. The 1986 Act generally imposed a corporate level tax on certain liquidating sales and distributions that were not taxed under prior law. Appreciation in corporate assets is thus now subject to a corporate level tax on the ultimate disposition of the business. The 1986 Act also included a new corporate minimum tax regime that includes as a preference a portion of the excess of the income that is reported for financial purposes over the amount of corporate alternative minimum taxable income.

In light of these changes, it is argued, many businesses (whether or not they seek access to public capital markets) may find it advantageous to operate in a non-corporate, single-level tax form whenever possible. Master limited partnerships, some argue, are used principally to obtain these tax advantages.

Others argue that the tax treatment of master limited partnerships simply facilitates desirable economic and business goals that are the primary reason for the formation of MLPs. For example, a rollout transaction often has the principal purpose of enhancing the value of the corporation's stock by highlighting certain corporate assets that previously were undervalued. The transaction can also permit the removal of debt from the corporation's books, further enhancing the value of the corporation's stock. In addition, by removing desirable assets from the corporate structure, the transaction may serve as a protective measure against hostile takeovers.

Another business reason stated for forming a master limited partnership is to raise capital without incurring additional debt, and without diluting the interests of existing shareholders. Also, it is contended, MLPs may offer business advantages over other present-law passthrough entities, such as REITs or RICs, which are restricted in the types of investments, nature of income, or management arrangements they may have (even though entities such as REITs may be more attractive than MLPs to certain tax-exempt investors, due to unrelated business income concerns). In the case of acquisitions (equity buyout) MLP transactions, the formation of the partnership permits the corporation to accomplish a buyout of subsidiary assets without debt and possibly at a higher price than otherwise possible. Thus, it is argued, MLP formation takes place for legitimate and substantial business reasons and should not be curtailed.

Erosion of the corporate tax base

Supporters of proposals to tax publicly traded partnerships as corporations argue that the continued growth of master limited partnerships may cause erosion of the corporate tax base, and a serious revenue problem eventually will result unless Congress takes action.

They assert that master limited partnerships conduct business activities that otherwise would be conducted in corporate form. They point to the fact that the formation of many master limited partnerships has been through transfer of assets of a corporate sponsor to the partnership; even in a rollup transaction, the business activities of the partnerships are of a type that may be conducted by corporations. Thus, to the extent that such activities would have generated income subject to two levels of tax in corporate form, and such activities are subject to only one level of tax when conducted in partnership form, the corporate revenue base is eroded.

Opponents say that disincorporation through the use of master limited partnerships may not cause a serious revenue problem, or may not cause a significant loss of short-term revenue from the corporate tax base. There are several alternative arguments that have been made in this regard. Each argument is based on the premise that the use of master limited partnerships represents a new financing option for corporate managers for funding corporate investment activities, and suggests that this new option is absorbing capital that otherwise would have been applied to finance corporate activities in a way that would not have generated a double tax in the first place.

Existing methods of obtaining capital for corporate activity are principally the following: (1) raising funds through issuing corporate stock (equity financing); (2) raising funds through borrowing (debt financing); and (3) using retained corporate earnings.

The earnings on an equity-financed corporate business activity are subject to the double tax, to the extent they are paid out, because the corporation is taxed when it earns the income, and the taxable holders of the equity (shareholders) are taxed when the income is distributed to them. Thus, equity-financing a project may have a relatively high tax cost.

The earnings on a debt-financed corporate business activity, by contrast, are generally not subject to two levels of tax to the extent paid as interest, because the interest on the debt is deductible and shelters the income earned at the corporate level from the corporate tax. The only level of tax paid on such earnings is paid by the person to whom the income is distributed. To the extent the income is paid in the form of interest to the lender, and the lender is a taxable entity, the income is subject to tax in the lender's hands. Some lenders (such as pension funds) may be tax-exempt, however, so income on debt-financed corporate activities that is paid to a tax-exempt lender escapes both levels of tax normally applicable to income earned in a corporation. To the extent that corporate income is not paid out as interest but is used to amortize principal or otherwise exceeds the deductible interest amounts, it may be taxed at the corporate level (as well as to the shareholder). Because the overall tax cost of debt-financing a project is less than equity-financing it, it is said that debt financing is a less costly method of financing than is equity financing.

Corporations may also use retained earnings to finance their business activities. Retained earnings generally represent after-tax income of the corporation, but to the extent these amounts are not distributed to shareholders, and instead are used to finance income-producing activities of the corporation, only the earnings from the income-producing activity (to the extent they are distributed to shareholders) are subject to two levels of tax; the amounts used to finance the project are subject to only the corporate level of tax (which under present law is higher than the individual rate). The price of the corporation's stock may, however, reflect the retention of earnings, and thus market turnover in the stock (for the period of retention) will generate taxable gains.

Those who argue that the growth of master limited partnerships may erode the corporate tax base assert that investments in MLPs are in whole or part a replacement for investments in corporate equity rather than corporate debt or other vehicles for corporate financing that would not generate two levels of tax. They assert that corporate debt in general (or debt in the economy) may not be declining, and argue that even if a particular corporation replaces its debt with MLP equity, others will borrow the amounts not borrowed by that corporation.

They also assert that if MLP capital is, to some degree, replacing retained-earnings financing by corporations, it replaces capital the income on which is ordinarily subject to two levels of tax. While the retained earnings are not distributed and thus themselves not subject to current shareholder level tax, the corporation's stock increases in value to reflect the retention of earnings, so that to the extent there is turnover in the stock there is current taxable gain. The future distribution of the retained earnings may generate losses should the stock decline in value to reflect the corporation's decline in net worth after the distribution, but the tax on the distribution of earnings to shareholders would offset such losses. Thus, they argue, retained-earnings financed projects should be considered as taxed comparably to equity-financed projects, and the replacement of retained-earnings corporate financing with MLP capital financing may cause a reduction in tax attributable to the loss of corporate-level tax on the entity's income. Also, earnings on MLP financing may be taxed at individual tax rates, rather than at the higher corporate tax rates.

Some who argue that MLPs will not erode the corporate tax base assert that capital contributed to master limited partnerships is equivalent to corporate debt. Corporations tend to transfer debt-encumbered assets to master limited partnerships, and the debt is then frequently paid off with the equity capital raised by offering the master limited partnership units to the public. Thus, they argue, the amounts invested by the public in master limited partnerships (income which is subject to one level of tax) are replacing corporate debt. Corporate debt-financed income is subject to one level of tax due to the deductibility of interest (as described above). They also assert that tax-exempt organizations tend not to invest in partnerships due to the unrelated business income tax consequences, so that MLP partners are generally taxable persons. Thus, they argue, the replacement of corporate debt with master limited partnership equity (also subject to one level of tax) should not generate a revenue loss, and is not likely to erode the corporate tax base.

Some also argue that MLP capital partially supplants the use of retained earnings to finance corporate business activities. It is argued that corporations will cut their dividend payments to finance investments sooner than they will issue new stock, because, they argue, retained-earnings-financing has a relatively low cost compared to new equity financing. Another reason for making the choice to cut dividends rather than issue stock, it is said, is to avoid diluting the holdings of existing shareholders.

To the extent that they can raise capital indirectly through MLPs in which they are general partners, however, corporations can maintain dividend levels. Thus, the fact that MLP earnings are subject to only a single level of tax is offset by the earlier distribution (rather than retention) of earnings to shareholders, and earlier tax on those distributed earnings. Those who take this position suggest that future growth in the corporate tax base may be eroded, however, to the extent that capital is invested in MLPs instead of corporate equity.

Finally, opponents of taxing MLPs as corporations assert that erosion of the corporate tax base through disincorporation is caused by the reversal in the differential between the corporate and individual tax rates. Under the tax rates set by the 1986 Act, the corporate rate is higher than the individual rate, and this motivates investors to select forms of investment taxed at individual rather than corporate rates (such as partnerships and S corporations). The incentives to disincorporate would be diminished, they argue, if the corporate rate were lower instead of higher than the individual rate. They also point to the fact that capital gains are taxed at a higher rate, since the 1986 Act, as a further disincentive to invest in corporate stock. It would not be necessary to tax master limited partnerships as corporations if the corporate and capital gains rates were reduced.

Administrability

Supporters of taxing master limited partnerships as corporations argue that trying to apply the partnership tax rules to the operations of a publicly traded entity is overwhelmingly complex. Those rules were never designed for publicly traded entities, they argue. It is virtually impossible to ensure that income is being accurately measured; further, enforcing the results of audits of partnerships with thousands of holders is highly impractical. The concept that a partnership terminates if more than half its interests change hands, as is true under present law, is thoroughly inconsistent with the notion of public trading. Further, it is argued, the fact that fungibility of master limited partnership units is a serious concern in every master limited partnership formed other than by a single primary offering is an indication that tax status as a partnership is incompatible with public trading.

Opponents of treating master limited partnerships as corporations acknowledge that the partnership rules are complex, particularly in application to publicly traded partnerships, but point out that the rules have always been complex, and that the corporate rules are also complex. They argue that the flexibility provided by the partnership rules should be preserved. They assert that the administrability concerns, though serious, are not insurmountable. In answer to the concern that it is difficult to ensure that income is accurately measured and reported, it has been suggested that withholding on partners' income at the partnership level be instituted, as a means of ensuring that the sophisticated calculations needed are done consistently.

Other opponents of treating master limited partnerships as corporations have suggested that administrative concerns be addressed by restricting partnership allocations, basis adjustments, and long-term debt, and requiring collection of tax liability at the partnership level, while preserving single-tax treatment for income (with no passthrough of net losses). They argue that this set of simplifications would respond to concerns regarding administrability by eliminating the applicability of rules leading to enforcement difficulties, and would also substantially solve audit and tax collection issues that some perceive under present law. Those recommending this regime for publicly traded limited partnerships also contend that treating income of the entity as portfolio income under the passive loss rule would have the same effect as treating the partnerships as corporations paying dividends (which are generally portfolio income), without having to impose a harsh two-level tax regime.

Competitive advantage

Supporters of taxing master limited partners as corporations assert that their use gives some taxpayers a tax-created competitive advantage. They argue that mature businesses with a steady cash flow, that can be marketed effectively as public partnerships because of the tax-advantaged yield, are unfairly favored over start-up companies or those with high capital expenditures, which cannot take advantage of the master limited partnership structure. Favoring one type of business investment over another creates new economic inefficiencies of the type that the 1986 Act was designed to reduce.

Opponents say that master limited partnerships have a limited utility. As a financing technique, they are available to large, mature business that already have a choice of financing method including the use of debt, retained earnings or newly obtained equity capital, and that thus already have an economic advantage over other types of companies. It is not a problem specifically attributable to the use of master limited partnerships that causes a competitive disadvantage, but a condition of the market place. Eliminating a possible competitive advantage for some companies is consequently not a reason to change the tax treatment of master limited partnerships, they argue.

Avoidance of the passive loss rule

Supporters of taxing master limited partnerships as corporations contend that they can be used to eviscerate the passive loss rule unless they are treated as corporations. Because activities owned in the form of limited partnership interests are treated as passive activities (except as provided in regulations which have not been issued), master limited partnerships could be used to generate passive income for the purpose of absorbing passive losses that otherwise would not be currently deductible. Income from master limited partnerships is essentially equivalent to corporate dividends, in that it arises from business activities ordinarily conducted in corporate form, and represents a steady stream of positive income. Therefore, master limited partnerships should be treated as corporations, and the income from them should be acknowledged as portfolio income (that cannot generally offset passive losses, under the passive loss rule).

Opponents of this notion point out that the passive loss rule contains a specific grant of regulatory authority to the Treasury Department to treat net income or gain of limited partnerships as portfolio income. This regulatory authority is broad enough to treat the income of any limited partnership, not just publicly traded limited partnerships, as portfolio income, they argue. Consequently, legislative action to treat master limited partnership income as portfolio income by transforming it into dividend income through reclassification of such partnerships as corporations is not necessary.

B. Other Partnership Issues

Other partnership tax issues, not specific to master limited partnerships but affecting partnerships generally, have been raised by some commentators. Such issues include those relating to partnership allocations, and to the treatment of partnership liabilities.

Partnership allocations

As described in Part II.A., above, present law permits partners substantial flexibility in allocating among themselves items of partnership income, gain, loss, deduction and credit, so long as the allocation has substantial economic effect. Some have argued, however, that the statutory standard is vague, and that the recently promulgated Treasury regulations setting forth guidance as to when allocations have substantial economic effect are flawed. The regulations may allow sufficent flexibility in arrangements among partners that they essentially permit the sale of tax benefits by tax-exempt or low-tax partners to high-tax partners. Although the passive loss rule enacted in the 1986 Act substantially curtails the current use of losses to shelter non-passive income in the case of partners who are individuals, the passive loss rule has no application in the case of widely held corporations. Thus, it is contended that the opportunity still exists to sell tax benefits through the use of partnership allocation techniques. In particular, allocations based on nonrecourse debt, and shifting allocations, may offer such opportunity.

Allocations with respect to nonrecourse debt

Current Treasury regulations have been criticized as too generous, especially with regard to allocations of losses attributable to nonrecourse debt. Since any special allocation to a partner which is attributable to nonrecourse liability is without economic effect, such an allocation, in order to comply with the requirements of the statute, must be determined in accordance with the partner's interests in the partnership. Some suggest that an approach such as that of the regulations, looking principally to whether the partner would be subject to tax on potential gain arising from foreclosure or disposition of the nonrecourse-financed property is not a sufficient standard under the statute for determining a partner's interest in a partnership. The regulations, however, exclude from consideration other facts and circumstances, particularly facts bearing on the economic sharing of profits and losses aside from tax consequences, which would be required to be considered in determining whether allocations not attributable to nonrecourse liability satisfy the statutory standard.[22] It has been suggested that the validity of an allocation of partnership losses attributable to nonrecourse debt should be evaluated on the basis of the relative investment by the partners, and the economic sharing of cash from operations, proceeds from a sale of assets, and proceeds from a refinancing of assets.[23] The application of the regulations to nonrecourse liabilities has been criticized as offering a vehicle for the transfer of tax benefits similar to safe harbor leasing.[24]

Others have contended, however, that the regulations, insofar as they relate to the treatment of losses attributable to nonrecourse debt, are a valid and appropriate interpretation of present law. It is contended that a direct owner of property could take deductions attributable to basis provided by nonrecourse debt (even though the lender bears the economic risk of loss) and would be charged with gain to the extent of the difference between the reduced basis and the outstanding debt on disposition of the property. Thus, it is argued, partners holding property through a partnership should be able to receive the same treatment, whether or not the partnership involves shifting allocations, so long as the partner who receives the deduction would ultimately bear the gain-chargeback.

Shifting allocations

The statutory "substantial economic effect" test has been interpreted to permit shifts in partnership allocations. Both courts [25] and the Internal Revenue Service [26] have taken the position that shifts in allocation ("flip-flops") are valid under section 704(b).

For example, in a typical flip-flop, often a large proportion of a newly formed partnership's initial losses and deductions (perhaps 99 percent) flow through to partners with high taxable incomes who can use the tax benefits. This allocation arrangement frequently remains in effect until these partners have recouped their initial investments, and perhaps some additional return, whereupon the allocation shifts so that losses (which are much smaller after the initial years) and profits and distributions (which may have increased if the partnership's business has obtained a firm footing) are allocated in greater proportion to the partners who are tax-exempt, or in a low tax bracket. This type of flip-flop can serve the purpose of giving investors an initial high-ratio writeoff, while keeping a substantial profits interest for the tax-exempt partner.[27]

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[22] For example, an article written prior to the promulgation of the proposed regulation suggested that a gain-chargeback provision would not satisfy the statutory requirements as applied to nonrecourse liability and that the allocation of tax benefits must be compared to economic benefits calculated without regard to tax benefits in order to determine the validity of the allocation. Krance and Sheffield, "Beyond Orrish: An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt is Involved," 60 *Taxes* 937 (1982).

[23] American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 251.

[24] Comments of the Committee on Partnerships of the New York State Bar Association Tax Section (May 12, 1983), at 32-38 (regarding the regulation as proposed).

[25] See, e.g., *Hamilton v. U.S. 687* F.2d 408 (Cl. Ct. 1982), holding that allocation of partnership losses and income primarily to limited partners until "payout" (recoupment of their capital contributions), and thereafter a shift in allocation of these items primarily to general partners, did not constitute nonrecourse loans from the limited to the general partners, but rather both allocations were valid.

[26] Treas. Reg. sec. 1.704-1(b)(5), Example 16(ii).

[27] Congress has discouraged some flip-flops designed to achieve other objectives. For example, leveraged buy-out transactions have been structured so that a corporation with large net operating loss carryovers and a new corporation formed by buy-out investors enter into a partnership

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It has been suggested that the opportunity to sell tax benefits, rather than capital recoupment or profit motive, is the reason for structuring shifting allocations in a partnership agreement. Thus, shifts in allocation could be treated as invalid. For example, a shifting allocation might be invalid where a substantial part of a partner's expected return on investment is likely to be derived from tax savings rather than from ultimate economic profit in the venture). In such circumstances, an appropriate allocation could be redetermined on the basis of each partner's interest in the partnership, taking into account the partner's share of distributions, liquidation proceeds, and proceeds of refinancing partnership profits, as well as the extent of his maximum risk of economic loss (regardless of tax losses).

It has often been said that the provisions of subchapter K were crafted to afford partners flexibility in arranging their affairs. Thus, a proposal to invalidate shifting allocations, where a substantial part of an investors' return is likely to be derived from tax savings, might be criticized as inappropriately preventing partners from arranging the tax results of their agreement in a manner which reflects the true economic reality of the transaction. Thus, for example, if partners all agree that the price of a partnership interest comprised of receiving an allocation of 99 percent of partnership losses and profits until the initial contribution is recouped, followed by an allocation of 60 percent of partnership profits, is equal to 99 percent of the partnership's initial capital requirements, then this arrangement should be respected for tax purposes. It is also argued that if an investor's expectation of recouping his investment is speculative or contingent, and he may actually lose his money, the investment is in the nature of equity, and tax losses, reflecting the possible economic loss of his investment, should be permitted to flow through to him under a shifting allocation arrangement.

Proponents of invalidating shifting allocations might argue that part of an investor's expected return from an investment with a high initial loss allocation to him may consist of the tax savings which the immediate tax sheltering affords. Thus, the "economics" of the investment are in part determined by its tax results. To the extent the partner is allocated an initial share of losses greater than his ultimate share of profits, it has been argued that the transaction resembles a small capital contribution and a larger loan by the partner to the partnership. (This resemblance might arguably increase if the investor realistically expected the venture to repay his initial investment.) Instead of interest, he initially receives tax savings. When the amount of the hypothetical loan has

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which acquires the assets of the target profitable corporation and incurs the debt for the acquisition. The profits of the partnership were allocated 90 percent to the loss corporation for a limited period of time (for example the period over which cash flow of the venture is expected to be used to pay down the debt incurred to acquire the assets). Thereafter, profits of the partnership were allocated 90 percent to the other corporation. The loss corporation would be entitled to distributions with respect to its capital account build-up during the initial period, but over a very long period of time (e.g., 25 years), with a relatively low amount of guaranteed payments in the nature of interest. The transaction was intended to utilize the loss corporation's loss carryovers to facilitate the amortization of the acquisition debt. It also avoided certain limitations on the use of loss carryforwards that might apply if the loss and the profit corporation otherwise combined. The limitations on loss carryovers in the 1986 Act were intended to limit this type of transaction among others.

been recouped, he is left with a small equity participation in the form of a profit share. Thus, arguably, it is reasonable that the allocation of losses to him attributable to the sum he in effect loaned the partnership should be invalid, and allocations to him should be redetermined to reflect his interest in the partnership. Others contend that in the absence of a fixed obligation to repay the investment, the investor should not properly be viewed as a lender.

Some may contend that even if an investor's interest is in the nature of equity, the long-standing law permitting special allocations of tax losses encourages arrangements that constitute sales of tax benefits and warrants reconsideration.

Opponents could contend that invalidating certain shifting allocations is unwieldy and complex, and would virtually require a case-by-case analysis, especially in the case of different allocation ratios of different partnership items (such as depreciation, interest deductions, and the like). Thus, shifting allocations should continue to be permitted.

Treatment of partnership liabilities

As discussed in Part II.A, above, a limited partner generally includes in his basis for a partnership interest his share of nonrecourse liabilities of the partnership. This rule, in effect, increases the amount of partnership losses and deductions that a limited partner can deduct, in view of the limitation on the deduction of such amounts to a partner's basis in his interest. Other limitations on the deductibility of losses—such as the at-risk rules and the passive loss rules—may effectively nullify the inclusion of partnership liabilities in a partner's basis as a means of increasing the amount of deductible partnership losses, at least in the case of taxpayers to whom those rules apply. The at-risk rules and the passive loss rules do not, however, apply to widely held corporations. As a consequence, the issue of whether partnership liabilities, particularly nonrecourse liabilities, should be included in a corporate limited partner's basis, remains subject to debate.

Some assert that partnership recourse liability should be included in a limited partner's basis to the extent he could be personally liable for such debt, but that nonrecourse liability should not be included in basis because partners are not generally personally liable for such debt.[28] Under this notion, a partner's basis would be increased by his share of partnership recourse liabilities, to the extent he could be required to satisfy them (in the case of a limited partner, to the extent of his contribution obligation). It has been argued that such an approach might place more significance on the distinction between recourse and nonrecourse debt than economic factors might warrant in particular cases.[29]

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[28] See James S. Eustice, "Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Thoughts)," 39 *Tax Law Review* 345, 398 (1984). It is noted that this approach would "place extraordinary stress on the distinction between recourse and nonrecourse debt." *Id* at 399. Thus, another approach would be to give partners (and S shareholders) basis for entity debt without regard to personal liability, but it is also noted that such a rule would "perhaps facilitate tax shelters [and] . . . Congress may be reluctant to do anything that would facilitate tax shelters." *Id*. Current law provides that partners, but not S corporation shareholders, may include a share of entity debt in their basis for their interests. S corporation shareholders may include their basis in loans to the corporation in determining the maximum amount of losses which may be deducted by the shareholder.

Others would prohibit the inclusion of any partnership-level obligation in a limited partner's basis for his partnership interest. Under this view, a limited partner would not be able to include any nonrecourse liability of the partnership in his own basis for his interest, nor would the partner be able to include recourse liabilities incurred by the partnership in his own basis, even in the amount of his unpaid obligation to contribute to the partnership. Thus, only the amount of money and the basis of property actually contributed would be included in a limited partner's initial basis for his interest.

The rationale of this approach is that limited partners have an indirect relation to partnership-level liabilities. Further, because of their passive investor status and limited liability, limited partners are said to more closely resemble corporate shareholders, who may not include corporate debt in the basis of their stock, than they do direct owners of the leveraged property. This approach would thus treat limited partnerships as separate entities, rather than conduits, in determining the effect of partnership liabilities on a limited partner's basis. The effect of such a change would generally be to limit the deductions a limited partner could take from the limited partnership to the amount of his actual paid-in capital contribution (increased by his share of any undistributed partnership income and reduced by any actual distributions to him).

Those opposing such a proposal say that permitting inclusion of partnership recourse liabilities in a limited partner's basis can be said to give the same tax advantages as does debt financing of directly owned property.[30] This result is justified, some argue, because limited partners, like direct owners, could be required to satisfy such liabilities (at least to the extent of their unpaid contribution obligations).

The rule including a share of nonrecourse liabilities in a limited partner's basis for his interest (thereby permitting him to deduct greater partnership losses), has been similarly justified as an adaptation to the limited partnership situation of a principle based on the decision the United States Supreme Court in *Crane* v. *Commissioner,* 331 U.S. 1 (1947). Under the *Crane* approach, the basis of directly owned encumbered property generally includes the amount of the debt (including nonrecourse debt), for purposes of depreciation; when such property is disposed of, the amount realized includes the amount of the debt, for purposes of determining gain in the transaction. The recent case of *Tufts* v. *Comm'r,* 461 U.S. 300 (1983) treated the amount of the nonrecourse debt, even though in excess of the fair market value of the property, as an amount realized.

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[29] The distinction between recourse and nonrecourse debt "sometimes has considerable economic significance, but sometimes it has very little. It means much, for example, if a speculative stock is acquired on 90% margin, but not so much if a well constructed building in a stable neighborhood is purchased with a 40% down payment." Eustice, supra note 46, at 399.

[30] The approach of eliminating partnership recourse debt, up to the amount of a limited partner's future contribution, from a limited partner's basis has been criticized as not appropriate, where the future contribution is paid in at the time the recourse debt comes due and is used to pay it, on the ground that the contribution obligation is "so much like a general partner's liability" that it should be included in basis. American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 262-263.

Some assert that changing the current rule to exclude all partnership liabilities from a limited partner's basis would be fair, if the current rule is excessively generous in a limited partnership context. While limited partners would be treated differently from direct owners and general partners, the difference in treatment can be justified, proponents suggest, because limited partners more closely resemble owners of corporate stock than direct owners of partnership property. They also argue that the *Crane* rule on which the current rule regarding nonrecourse liabilities is based would not be generally abrogated,[31] but would simply become inapplicable in the limited partnership context to which it was extended.[32]

Opponents of the change could further argue that, even though a limited partner would under the changed rule be prevented from currently deducting partnership losses attributable to partnership liabilities, he would nevertheless have to take into account his share of partnership income attributable to them.

Proponents contend that this is not necessarily an unfair result if the losses which are disallowed due to noninclusion of partnership liabilities in a limited partner's basis are simply deferred and deducted against the limited partner's share of future income of the partnership, or when the partner actually pays any remaining contribution obligation.

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[31] Indeed, some have argued that the *Crane* principle of inclusion of nonrecourse liabilities in basis should be eliminated. See *Tufts* v. *Comm'r*, 651 F.2d 1058 (5th Cir. 1981) at n. 9, reversed, 461 U.S. 300 (1983).

[32] Although the current rules regarding a limited partner's share of partnership liabilities included in his basis for his interest are stated in Treasury regulations, it has been suggested that legislative authority would be required to change them due to the Congressional reenactment of various sections of the Code since regulations were promulgated. See American Law Institute. *Federal Income Tax Project—Subchapter K* (1984), at 259, n. 4.

Senator **Baucus**. The hearing of the Subcommittee on Taxation and Debt Management will come to order. Today's hearing is about the tax treatment of master limited partnerships. This is an issue which sounds esoteric—and in some ways is esoteric—but also one that has profound implications for the tax system of this country, for investors, and for the ability of business organizations and individuals to either raise capital for investment or to invest for own individual reasons.

Ever since we have had a corporate tax, we have been trying to figure out when an unincorporated business operates so much like a corporation that it should be taxed like one.

Beginning in the early 1980's, this debate began to focus on a new form of business entity commonly known as a master limited partnership. MLPs were originally developed in natural resources industries, but recently they have been used in other industries, for instance real estate, cable television, sports franchises, and a host of others. The Treasury Department estimates that there are now either in existence or being formed about 126 MLPs.

In some quarters, the development of MLPs has been viewed with alarm. We have heard warnings about widespread disincorporation and about potential erosion of the corporate tax base. Now, the Treasury, in particular, has called for tighter rules. Others, however, hail MLPs as a new financial instrument, a new investment opportunity, one that in our flexible, mobile society should be available for investors and for business organizations to use.

In light of this, Chairman Bentsen asked the Taxation and Debt Management Subcommittee to hold today's hearing.

The hearing is designed to give both the Treasury and those others involved in the development of MLPs an opportunity to express their views.

The first issue is economic policy. We must consider the extent to which, as the Treasury Department argues, MLPs give some companies an unfair tax advantage. On the other hand, we must also consider whether MLPs create a new financing option and other potential long-term benefits for the economy.

The second issue is revenue. Given our huge budget deficit, we simply cannot afford a significant erosion of the corporate tax base. There is, however, a heated debate about whether MLPs in fact will cause that erosion.

The third issue is compliance. The Treasury argues that the proliferation of MLPs may undermine tax compliance. We must consider the extent of the problem and how it can be addressed most effectively.

Our first witness is Assistant Secretary of the Treasury for Tax Policy, Mr. Roger Mentz. Mr. Mentz, why don't you begin with your testimony?

STATEMENT OF HON. ROGER MENTZ, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, U.S. TREASURY DEPARTMENT, WASHINGTON, DC

Mr. **Mentz**. Thank you, Mr. Chairman. It is a pleasure to be here this morning. My written statement is virtually the same as I delivered last month to the subcommittee of the House Ways and Means Committee, and I would ask that it be printed in its entirety in the record.

Senator **Baucus**. It will be included.

Mr. **Mentz**. Thank you, Mr. Chairman. I will try to keep my remarks brief and just touch on the primary issues. As you indicated in your opening statement, the problem that we are wrestling with is a classification of an entity for tax purposes. It is, as you said, an esoteric issue, but one that has very practical and very significant revenue effects.

Generally, any corporation that is incorporated under the laws of a State is automatically taxed as a corporation, and there is no further investigation into its tax characteristics; but if an entity other than a domestic corporation is created, an issue arises as to whether that entity is treated for U.S. tax purposes as a partnership, a trust, or an association taxable as a corporation.

We have a set of regulations that attempt to make that distinction; and those regulations, because of historical reasons, have a bias in them in favor of classifying entities as partnerships. That bias goes back to the old days when there was a question as to whether doctors and other professionals could get advantages from pension plans and other qualified plans that were only available to corporations.

The regulations at that time were slanted to try to classify these organizations as partnerships. That is no longer relevant, but nevertheless, the regulations with their bias continue to favor the classification of entities as partnerships. In effect, it is kind of a tie-goes-to-the-partnership rule.

And that really has been the basis of many of the tax shelters that we have seen in the 1970's and early 1980's where a limited partnership or the limited partners are not really at risk, have virtually nothing to do with the management of the entity, and nevertheless are entitled to pass-through treatment of losses and other tax attributes of the entity.

That has been a significant factor in tax shelters; but only recently—since 1981—have the tax lawyers gotten even more creative and have had the limited partnership interests subject to free transferrability, marketability, and indeed, listing on the stock exchanges.

And what we see now are master limited partnerships with shares freely traded on the New York Stock Exchange and other exchanges.

If you will look at Table 2, we have a little summary, year by year, of what has happened in this so-called "master limited partnership" area. You will see that in the early days—1981, 1982, 1983—there were very few of these. They were exclusively, really, in real estate and natural resources.

Basically, wasting assets, passive assets, were put into a master limited partnership and paid a cash flow to the investors. It was not really a very significant phenomenon and one that really was not given too much attention by the Treasury or by others in the tax-writing area.

But recently, and particularly as a result of tax reform, there has been a much greater economic incentive for an organization to be operating in noncorporate form. Avoidance of the corporate level of taxation, getting into pass-through form has become even more attractive than it was before tax reform. You can see that in Table 1, attached to my written statement. Table 1 is an economist's model of the relative advantage of being in a partnership versus a corporation.

All of these numbers—since they are all positive—indicate a more favorable tax result from noncorporate form as against corporate form; but you will note that there is a strong advantage—a stronger advantage—after the Tax Reform Act—as the column on the right-hand side shows. It is almost 2 to 1 over what it was prior to tax reform.

The reason is, this is an economic model. It takes into account all the factors of tax reform, all the changes—investment credit, depreciation, and so on. It is intended to model the entire tax system; and without getting into the esoteric reasons why this is so, you can perhaps understand it a little bit simplistically if you think about what tax reform did.

Tax reform raised about $120 billion, as we estimated it last year, from the corporate sector. In other words, corporations were going to, as a whole, pay roughly $120 billion more money to the Federal Government over 5 years.

Given that change, it is obviously better for any specific corporation to get out of that corporate pot into the unincorporated pot so that the entity will not be hit by part of the $120 billion additional tax.

This is the economic force that is pushing more and more entities into noncorporate form, into MLP form. And as you indicated, we have seen a lot of them in recent years, particularly last year—not just the natural resources, not just real estate; but we have seen sports franchises, cable TVs, gas pipelines, motion picture businesses, health care, home building—a whole variety of active businesses that have traditionally operated in corporate form switching over into MLP form. This is certainly a trend, a trend that we find disturbing. Active businesses, businesses capitalized with debt, MLPs—these days they are coming out with not just equity units, but with debt—sometimes convertible debt.

You have MLPs looking very much like corporations. In fact, from the standpoint of characteristics, it would be very difficult, if not impossible, to distinguish an MLP from a corporation.

It has been suggested, particularly by the academic community, that Treasury ought to address this problem in regulations, that it is really a tax policy issue that makes very little sense to have an entity that is virtually identical to a publicly traded corporation with very advantageous tax consequences over such corporations; and why don't we just change our regulations?

That may be perhaps close to a unanimous academic view, but our judgment is that this subject affects too many taxpayers, that there are too many interests at stake; and it is not one that ought to be handled just by regulations. It should be handled in the legislative arena.

You mentioned revenue as one of the important considerations. Table 3 provides an analysis of the revenue. First, the Treasury supports—were legislation to be enacted that treates MLPs as corporations—a grandfathering of existing MLPs for some period of time. Basically, to summarize it very quickly, if one were to grandfather existing master limited partnerships, then, you would see that there is not a tremendous amount of revenue involved in this proposal. If you are dealing with only master limited partnerships that are traded in some organized form—in a stock exchange or in a NASDAQ over-the-counter market, the revenue is only about $665 million for the 5-year budget period. The revenue cost, however, of not doing anything—of leaving the situation alone—is, we believe, significantly more than that; and what will happen is that, as more and more MLPs are formed and indeed active businesses see the advantage of organizing in MLP form, you will have a greater erosion and, therefore, the baseline will change.

We believe it will result in a revenue cost that is significantly more than the $665 million. What we are talking about here this morning—what Treasury is talking about—is a revenue protection position, not really revenue enhancing.

It is true that in out years there is more revenue in this proposal, as you get beyond the grandfather period; but my main message to you is that it is not so much that you are going to raise a dramatic amount of revenue from treating MLPs as corporations, but that you will protect the revenue, protect the corporate baseline from eroding.

As I mentioned, transition is an important issue. We think that whomever is in MLP form ought to be allowed a grandfather period; five years seems to us to be about right as a reasonable period. We also in the testimony suggest a natural resource exception. The reason is that, historically, natural resources—particularly oil and gas—have been operated in a partnership form; and we have pass-through entities—real estate investment trusts, regulated investment companies, REMECs—that have a single level of tax or pass-through treatment for real estate ventures, for investment companies, for mortgages.

We think a similar concept with appropriate similar limitations would fit well into the natural resources mold, and that is the reason why that suggestion is in the testimony.

This testimony is consistent with the Treasury testimony of June 1986 where we first brought this subject to the attention of the Select Revenue Subcommittee of the Ways and Means Committee. The Administration still has this issue under review, as indicated in the last paragraph of my testimony.

Let me say, Mr. Chairman, that you will undoubtedly hear well articulated reasons why MLPs are a desirable form of entity and a favorable way of raising capital, eliminating debt, that we shouldn't worry about it since it is a small part of the capital-raising market, and it is healthy in that they go in favor of a single level of taxation and thereby provide a sort of self-help integration.

Those testifying will, of course, be representing their clients, as they should be. I am testifying this morning as a representative of the Treasury Department, and my client is the United States Government. I am expressing a concern that we in the Treasury Department believe this is a serious problem; one that has to be considered and deliberated by this committee and by the Ways and Means Committee; and the concern is that we have a potential here for erosion of the corporate tax base that was so important, so fundamental in coming up with tax reform last year. And if we erode that base, we are not going to have the revenue that we are counting on to keep the rates where we all agree we wanted them to be.

So, that is the reason that I am here this morning.

Let me close by saying that this is, in all probability, my last testimony as a representative of the Treasury Department before the Congress; and I want to express my gratitude to particularly this committee for the kindness and consideration that all have shown to me. It certainly has made my stay at Treasury the highlight of my professional career, and I am very grateful to you for the kindness that you have shown to me.

Thank you very much.

Senator BAUCUS. Thank you very much, Mr. Mentz. Does your testimony represent the view also of the Administration, that is not only of Treasury but of the Administration?

Mr. MENTZ. The Administration's view, as stated in June of 1986, was a suggestion that Congress look at the possibility of treating master limited partnerships as corporations.

Today, my view—and it is articulated in the last paragraph of the testimony—represents the Treasury view. The Treasury view has not moved at all from where we were last June.

The Administration is reviewing—continuing to review this issue—because of the effects that changes in classification of MLPs would have on activities traditionally conducted in partnership form. The Administration still has the issue under review. Treasury is exactly where the Administration was in June of 1986.

Senator BAUCUS. So, as I understand the difference, Treasury believes that MLPs should be taxed in corporate form, but with appropriate grandfathering with a natural resources sort of a passive investment kind of a pass through?

Mr. MENTZ. That is right.

Senator BAUCUS. Whereas it is the Administration's view that the issue should be studied further. Is that correct?

Mr. MENTZ. They are studying it further. That is exactly right.

Senator BAUCUS. Some folks note that we already have integration in effect; that is, even though there is a theoretical two-tier taxation of corporate organizations, corporations can raise capital through debt or retain earnings or have Subchapter S corporations, so that in fact we already have integration even though in theory we don't.

The view is that if we already have it, why shouldn't we allow MLPs to continue to operate. What is your response to that?

Mr. MENTZ. We have integration in certain explicitly authorized forms—regulated investment companies, real estate investment trusts, REMICs, Subchapter S. Certainly, we don't propose that any of those should be eliminated.

Indeed, the natural resources exception would be a statutory way of dealing with what we think would be a logical form of integration, within limits, for natural resources; but I think the two self-help integration forms that are invoked today that are not expressly covered by statute should be subjects of concern.

They are at Treasury, and I think they should be for Congress as well. You mentioned debt. We think that the highly overleveraged corporation—the corporation that has a hundred-to-one debt-to-equity ratio and 15 different tiers of debt—and when you get down to the 14th and the 15th tiers it is so far subordinated and it looks so much like stock—allowing deductions for interest paid on that debt is simply not the right tax policy answer.

And that form of integration, I think, has to be looked at, whether it is looked at by Treasury alone through regulations or in conjunction with Congress. I think it is an important area to look at.

Similarly, MLPs are a form of ad hoc integration, and Treasury agrees that integration is a desirable objective; but the trouble with MLPs is some companies can use them and others cannot. General Motors cannot get into MLP form; it would be prohibitively expensive to liquidate General Motors; but if a DeLorean II car company comes along, they you would be foolish not to use an MLP form. And by doing that, they would have an advantage over any other competitor.

That kind of imbalance simply does not make sense as a tax policy matter, and that is the reason we suggest that you ought to think it over.

Senator **Baucus**. So, the Treasury's argument is the fairness argument, that is that General Motors would find it prohibitively expensive to convert to MLP status, whereas a new startup automotive company could more easily organize itself as an MLP. So, it is unfair to allow the new startup to have that favorable tax treatment compared with other companies. Is that correct?

Mr. **Mentz**. Yes. That is right. It would be as if—to use a silly example—you had a rule that said all corporations doing business in Montana would not have to pay a corporate level tax.

Senator **Baucus**. You are on the right track there now. [Laughter.]

Mr. **Mentz**. I thought you would like that. [Laughter.]

It seems to me that folks who are arguing that this is good because it takes you away from double tax would have to say, gee, that is a good idea, too, because at least for those corporations, they would be moving away from double tax; but I think that is absurd.

Senator **Baucus**. I have a few more questions, but I will turn it over to Senator Matsunaga.

Senator **Matsunaga**. Thank you, Mr. Chairman. I am sorry to learn that you will be leaving us. We will have to look for a new whipping boy. [Laughter.]

Mr. **Mentz**. I will miss those daily whippings.

Senator **Matsunaga**. But I suppose you will be back before us making five times the salary and advising us just the opposite of what you are advising us today. [Laughter.]

Mr. **Mentz**. That certainly has been the tradition of my predecessors. [Laughter.]

Senator **Matsunaga**. Mr. Secretary, and this may be the last time we address you as "Mr. Secretary," unless like Ambassadors you keep your title.

Mr. **Mentz**. I would be delighted if you continued to address me as "Mr. Secretary."

Senator **Matsunaga**. To follow up on the question raised by the chairman, isn't there an advantage to organizing as a corporation rather than an MLP?

To begin with, the limited liability of a corporation does not fully apply to MLPs, does it?

Mr. **Mentz**. I think the advantages of organizing as a corporation as opposed to an MLP are virtually negligible. There is one advantage; and that is, in order to operate as an MLP, you have to keep very intricate records because the partnership rules are not designed for publicly traded units; and therefore, you have a very difficult time. And it is only through the use of computers that even an approximation can be made of how the publicly traded units fit into the partnership tax model in Subchapter K.

That is a burden for anyone who has an MLP. It is also a burden for the Internal Revenue Service. That is, I suppose, the principal burden. What you were referring to, I believe, in your question is the theoretical possibility that a limited partner of an MLP would be liable for distributions made to him in the event that there was some tremendous liability of the MLP, whereas a corporate shareholder does not have that liability.

I think, as a practical matter, that point is so heavily discounted by the market that it really diminishes to practical irrelevance.

Senator **Matsunaga**. What about the difference of liability as between general partners as compared to corporate executives?

Mr. **Mentz**. There is clearly a difference for the general partner. Most, but not all, MLPs have a corporate general partner so that they are able to limit the liability to some extent in any case. Some have individual general partners. There is no question that is a difference, but that is not a difference for the investing public.

Senator **Matsunaga**. But you will recognize that there are differences between corporations and MLPs?

Mr. **Mentz**. I would say there are differences, but I don't think they are differences that are significant enough to make a legal distinction as to their tax classification status.

Senator **Matsunaga**. So, as I understand your testimony, you support generally taxing MLPs as corporations?

Mr. **Mentz**. I think it is something that Congress should seriously look at. I think there are arguments on both sides, and I am sure you are going to hear them this morning; but on balance, where Treasury comes out is that it would be appropriate to take that step and to take it with a grandfather of existing MLPs and with a natural resources exception.

Senator **Matsunaga**. Are you saying that you are recommending that a study be made prior to passing any law at this time?

Mr. **Mentz**. We have studied it. We studied it carefully before we testified in June of 1986. We have continued to study it. We have all the offering materials on these 126 transactions. We have, I think, been fairly carefully involved in it. Now, there is a Treasury study that has been required on corporate taxation. That was provided for in the Tax Reform Act last year.

There would be some logic in deferring action on MLPs until that study is completed. When that study is completed, there may be something more on integration. There may be something more on corporate debt. I doubt frankly that Treasury is going to reach any new conclusions on MLPs, but it is possible that in the framework of the Subchapter C study you may get a different slant on it.

The disadvantage of doing that is you obviously have a lot more MLPs created in the meantime, which would probably be subject to any grandfather provision. That is a decision that reasonable men could differ on, and you may want to consider it.

Senator MATSUNAGA. I would like to ask one more question, Mr. Chairman. You mentioned grandfathering. Now, what sort of grandfathering would you suggest in the event that Congress decides to go ahead with Treasury's position?

Mr. MENTZ. I would suggest that you fix a date—whether it is today or yesterday or tomorrow or whatever—and you say all the master limited partnerships in existence and in operation at that time be allowed to retain their partnership status for a finite period of time—whether it is five years or whatever you judge—and thereafter the law applied to them as it does to every other. If you don't do it for a finite period of time, you create a really unfair differential between those that are in and those that are out.

And by the way, there is a separate issue as to how income from an MLP or gain from the sale of an MLP is treated for passive loss purposes; and there, I don't think you need to grandfather. I think the Treasury can deal with that in the regulations, or Congress can deal with it through enactment of a change in the law; but there, I don't think that there is the same compelling reason for a grandfather rule.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Senator BAUCUS. Mr. Secretary, you said the cost of doing nothing would be significantly higher than the positive current revenue estimates, basically because of the changed revenue base. What is your ballpark estimate of the cost of doing nothing—say, five years out?

Mr. MENTZ. It is hard to answer that question, Mr. Chairman. We have been looking at and trying to evaluate what that number would be. It is difficult because you have to get into projecting behavior in an area that is fast developing.

Senator BAUCUS. Could you give us a guess? You sound a little concerned. Your testimony has an underlying sense of concern in it. So, it seems that you must, therefore, have a certain feel for the magnitude of the cost of doing nothing, in your view.

Mr. MENTZ. I would say it is probably several billion, but that is a guess. What I am worried about—and I think it is a very legitimate worry—is if you look at the way the revenue losses add up, you will see that they escalate as you go out. So, you are looking at fiscal year 1988 and fiscal year 1989; it is not going to matter all that much.

If you are planning on being around this distinguished body for some period of time—1992, 1993, or 1994—it is going to be a problem. In my judgment, it is going to be a serious one. That is the overriding concern that I have.

Senator BAUCUS. What are the best nontax advantages of organizing as an MLP?

Mr. MENTZ. The best nontax advantage—that is usually called a nontax advantage—is that there is just a hell of an economic advantage because of the single level of tax.

Senator BAUCUS. I regard that as a tax advantage.

Mr. MENTZ. I do, too, but you will hear it argued as a nontax advantage. I don't think, Mr. Chairman, that if you classified MLPs as corporations, you would see any material number of MLPs out there. In other words, I don't think there are any significant nontax advantages. All the advantages, no matter what kind of cloth you wrap them in, would all be tax advantages.

Senator BAUCUS. To what extent would MLP capital financing be a substitute for equity financing, as opposed to other forms?

Mr. MENTZ. I think it is primarily a substitute for equity financing. I think that, while the argument is that MLP financing is used to pay off debt and, therefore, it is a substitute for debt financing and, therefore, it is good and it is wonderful and we are getting rid of the debt. In our overleveraged society, however, economists will tell you that it is unlikely that the presence of MLPs will in any material way affect the relative amount of debt and equity in the system.

And that is because the lender who has been paid off with an offering of MLP equity will end up lending in some other form of debt instrument, and the cash that came in to create the MLP that paid off the debt is most typically equity money that, if it were not there, would go to some other equity vehicle.

So, I think—Treasury thinks—that the notion that MLPs are really the way to solve our overindebtedness problem is simply fallacious. Furthermore, you will see that many of the new MLPs are capitalized significantly with debt.

That is, it is perfectly possible to have debt in an MLP, just as a corporation entity. Debt is something that your tax exempts and your foreign investors can invest in whereas they that may have a tax problem investing in the equity units of an MLP. It is perfectly possible for them to invest in a convertible debt instrument if they want the equity quicker. So, I don't see the debt argument as being a particularly persuasive one.

Senator BAUCUS. If we treat MLPs as corporations for purposes of taxation, how do we define those MLPs that should be so treated—the number of partners, the limited partners, the asset test? Should public trading be dispositive?

Mr. MENTZ. The definition is a difficult one. The way that we have been addressing it is publicly traded, and it is easy to define publicly traded if it is by reference to stock exchange traded or even NASDAQ traded, such that there is an over-the-counter market. That is easy to pick up that definition from the securities laws. It may be necessary to go somewhat further and deal with the situation where a publicly offered limited partnership is not registered on the stock exchange, but where there is a market made by one or more investment bankers so that you have, in effect, the same degree of shareholder liquidity as in a publicly held corporation.

That is one that, if you are interested in pursuing the suggestion, I think we would be pleased to work with you on.

Senator BAUCUS. What enforcement problems do you foresee if MLPs continue to grow exponentially, as you predict, and if Congress does not change the tax treatment of MLPs?

Mr. **Mentz**. We have serious concerns about administration and enforcement because the shares are traded so rapidly; the existing rules under Subchapter K of the Internal Revenue Code simply are difficult, if not impossible, to apply. For example, a partner in a partnership is supposed to pick up his share of income loss or attributes during the time that he was a partner. If you bought shares of an MLP today and sold them in the month of July, there is just no way that an MLP can administer itself in a way to give you your share of taxable income or loss or what-have-you that was produced during the period of your ownership.

That is very different than a 10-man partnership where you divide up the profits, you divide up the losses, and you figure out when a partner comes in and when he goes out; and it can be handled very easily. It is much more difficult, with major problems for the IRS, even if reasonable compliance can be achieved by the partnership; and that is a matter of some question.

Senator **Baucus**. What about advances recently in computer technology? Can't that handle all that?

Mr. **Mentz**. Advances in computer technology is the reason you have MLPs at all.

Senator **Baucus**. But can't computers also handle the enforcement problems?

Mr. **Mentz**. At present, we don't believe it does; and even if it allows MLPs to pretty much make a good-faith effort at compliance, it is going to be very difficult, if not impossible, for the IRS to audit. I think if you are going to stick with MLPs, we would certainly need some important compliance changes that would make it more administrable.

Senator **Baucus**. Senator Bradley?

Senator **Bradley**. Mr. Chairman, I wondered if Mr. Mentz had any thoughts about master limited partnerships and the passive income and loss rules?

Mr. **Mentz**. Yes, I do, Senator Bradley. As you recall very well in last year's Tax Reform Act, the decision was made that passive activities that generate losses, the losses would be in effect walled off and not made available for use against a taxpayer's salary, professional income, dividends, interest, and capital gains.

Unless the Treasury or the Congress does something about it, right now, income from a master limited partnership and gain from the sale of a master limited partnership is passive income, which means the passive income is going to be available for offset against those otherwise-unusable losses. The effect is that the income from an MLP, including the gain from the sale of interests in the MLP, would be effectively shelterable despite the efforts and the lengths that we went through last year to try to avoid the use of tax shelters.

That is hard to defend where it is essentially the same as a portfolio investment in stock where, of course, that income and gain are not eligible for such tax-free treatment.

So, I would say at a minimum the passive loss point ought to be dealt with in a way that income from MLPs is treated as portfolio income.

Senator **Bradley**. The last statement you made was that you thought that the gain or loss from——

Mr. **Mentz**. The gain or loss and the income from a master limited partnership—in other words, the income that passes through from the operation of an MLP—ought to be recharacterized as portfolio income rather than passive income so that it is not subject to being sheltered by otherwise unusable losses.

Senator **Bradley**. And you think that should be the case for all master limited partnerships?

Mr. **Mentz**. That is right; and in that case, I don't think that there is any grandfather protection that ought to be afforded.

Senator **Bradley**. So, no grandfathering on the passive loss, though you do propose a grandfathering on the question of whether the master limited partnership should be taxed as a corporation?

Mr. **Mentz**. That is right. And the reason for that distinction is that last year, certainly, your purpose was very clear that portfolio income wasn't going to be on the right side of the line; and this is really portfolio income just like income from stock.

Senator **Bradley**. And the grandfather date on the corporate rate, what do you suggest? I didn't hear your testimony.

Mr. **Mentz**. I would suggest that the appropriate way to deal with the grandfather would probably be five years. In other words, an MLP that is in existence today—Mesa Petroleum, for example—I would say a period of five years would be reasonable.

Senator **Bradley**. Five years from the time it was——

Mr. **Mentz**. Five years from the time that you act.

Senator **Bradley**. Yes. You have come out fairly strongly on the issue of taxing an MLP as a corporation. There are not a whole lot of people who have made that case. Why do you feel so strongly about it?

Mr. **Mentz**. I feel that it is the obligation of the Treasury Department to bring to the attention of tax-writing committees possible areas of erosion of our corporate tax base. We passed the Tax Reform Act last year that proposed to raise $120 billion from the corporate sector. That is one of the bases on which our rates are founded. In a way, it is the underpinning of tax reform. To the extent that gets eroded by MLPs, by excessive debt, and other areas, I think we jeopardize the tax system.

Senator **Bradley**. So, you are saying unless we move on this and do something and treat MLPs as corporations, and unless we move on passive loss, we have a potential problem here and a significant revenue loss?

Mr. **Mentz**. Yes, particularly in the out years. I think if you look at the numbers, you can say: What is the big deal? It is not really very much money, particularly if you grandfather and particularly if you have a narrow definition of "publicly traded." My answer to that is, as I said to the chairman, a number of you are going to be around here for a long time; your base is going to be eroded, and three, four, or five years from now, the picture is going to look a lot different than it does today.

Senator **Bradley**. So, unless we do this, the pressure will be on to raise rates—corporate rates?

Mr. **Mentz**. I think that is a risk, yes.

Senator **Bradley**. Thank you.

Senator **Baucus**. Senator Wallop?

Senator **Wallop**. Thank you, Mr. Chairman. I see we have a vote on, so perhaps I will ask a couple of questions and then submit the rest to Mr. Mentz to respond to in writing.

Senator **Baucus**. That will be fine.

Senator **Wallop**. Roger, as I understand it, you are recommending that the master limited partnerships be taxed as corporations, but are doing so without the support of The White House. Is that correct?

Mr. **Mentz**. The Administration—the entire Administration, including The White House—concurred in the testimony of June of 1986 that suggested to the Congress, and particularly to the Select Revenue Subcommittee of the Ways and Means Committee that master limited partnerships be considered to be taxed as corporations. A lot has happened since then. We have a lot more MLPs, and the issue has gotten a lot higher profile.

The Treasury Department, Senator Wallop, is exactly in the same position as it was at that time. The Administration is reviewing—still reviewing—the issue, primarily because of the effect that that might have on existing operations that are traditionally conducted in partnership form. And you will note in the testimony that there is a natural resources exception that is part of that same consideration.

Senator **Wallop**. I understand that, but one of the purposes—or at least one of the oft-stated purposes—of tax reform was to free up and smooth out the means of capital creation, capital attraction. Now, having found a way to smooth it out and make it more efficient, we seem to be on the threshold of taking it back. So, I sort of wonder why, with last year's repeal of the general utilities doctrine, it became very expensive for corporations to spin off or drop down properties into a master limited partnership. So, if we are going to see this disincorporation of America, as your testimony would suggest, shouldn't the short-term revenue consequences of such an action result in increased revenue to the Treasury because of the stiff taxes a corporation pays on disincorporation?

Mr. **Mentz**. I think there was significant disincorporation at the end of last year because of the impending repeal of *General Utilities*; but right now, the formation of MLPs is not happening because of disincorporations, at least not in the usual case; there may be a rare one.

But nevertheless, new ventures—spin-off situations—where the tax consequences can be tolerated are going to find their way into MLP form because it is much cheaper—tax-wise—to operate in that form. And I don't think we smoothed out the way of raising corporate capital. I wish you would smooth it out.

Senator **Wallop**. If that is the case then, your worries about disincorporation are probably not well taken. If the repeal of *General Utilities* means anything, it probably means that these new master limited partnerships will largely be roll-ups of existing partnerships. There is only a certain length of time in which that can go, and they wouldn't go into corporate ownership in any case.

I mean, I don't see how you can argue it from both ends.

Mr. **Mentz**. I think there will be new businesses. I mean, the next time somebody comes up with a DeLorean to compete with General Motors, that is going to be an MLP, Senator Wallop. I mean, there is just no responsible tax lawyer who would advise otherwise. I just think that this is a phenomenon that is catching on. Frankly, these hearings and the hearings on the House side have made it very clear to everyone what the advantages are of MLPs, and there are going to be more of them.

Senator WALLOP. Mr. Chairman, we had better go vote, but would it be all right if I submitted questions for Mr. Mentz to reply to in writing?

Senator BAUCUS. Absolutely.

Senator WALLOP. Thank you.

Senator BAUCUS. Thank you very much, Mr. Secretary. Before we leave, on behalf of not only myself but also the committee, I want to tell you how much we are going to miss you. You have been an exemplary public servant. In fact, I am hard pressed to think of anyone I have known in public service whom I can praise more than you. You have been a very forthright, honest, intelligent, and capable public servant, and all of us look forward to your further testimony before this committee and to meeting with you privately to explore tax issues.

I must say, as a lawyer, you have been a great advocate. You have been an exemplary model for your profession. In these days when there are some questions about the role of public servants, I think your performance is in marked contrast to some other models, and stands well for others in public service and maybe even younger people who may aspire to public service. I also wish you well on behalf of Senators Chafee and Denforth, who expressly asked to be remembered and to wish you well.

And I know you will do well. We expect to see you again, frequently. And I know that in whatever capacity you serve that you will do just as well and uphold your fine personal reputation. You have been a terrific person to deal with. We wish you well.

Senator WALLOP. Max, let me just echo that. Roger, you and I have had differences; but one of the nicest things about them is that they have been very straight-forward, and they have always been resolvable. That, too, is a tribute to the way in which you have conducted your office. I appreciate it and echo what Max has said. I expect that your handicap may go down a little bit now. [Laughter.]

Mr. MENTZ. I hope you are right. Thank you very much, Mr. Chairman and Senator Wallop.

Senator BAUCUS. We will recess for 10 minutes.

[Whereupon, at 10:58 a.m., the hearing was recessed.]

[The prepared statement of Mr. Mentz follows:]

For Release Upon Delivery
Expected at 10:00 a.m., EDT
July 21, 1987

STATEMENT OF
J. ROGER MENTZ
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to participate at your request in the Subcommittee's consideration of the taxation of publicly traded limited partnerships, commonly referred to as master limited partnerships ("MLPs").1/ We previously have testified on this subject in hearings before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, first, in June of 1986, and, more recently, on June 30 of this year.2/ Today's hearing provides the opportunity to analyze the MLP form of business organization, and, in particular, to consider how MLPs have been affected by the Tax Reform Act of 1986 (the "Tax Reform Act" or the "Act") and how the use of such entities has evolved over time.

1/ Unless otherwise noted, the term "master limited partnership" is not intended to refer only to those limited partnerships whose interests are traded on an organized exchange, but rather to the broader class of limited partnerships whose interests are, in fact, publicly traded.

2/ Statements of J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy), before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Hearing on Issues Relating to Pass-Through Entities, June 9, 1986 and June 30, 1987.

The proper income taxation of pass-through entities such as MLPs is part of the broader issue of the income taxation of business enterprises generally. In this context, basic tax policy principles support taxing income from all business activities at equivalent rates, regardless of the form of business entity. Current law departs from those principles in maintaining separate regimes of taxation, resulting in different effective tax rates, for pass-through entities and for businesses operated in corporate form.

In our 1986 testimony before the House Select Revenue Measures Subcommittee, we reiterated our historical support for the concept of integrating the corporate and individual income tax systems in order to achieve greater neutrality in the taxation of business enterprises. We also noted, however, that integration appeared to have been rejected in the political debate then centered around tax reform. Based on the assumption of a continued and substantial separate corporate income tax, we suggested that Congress consider classifying MLPs as corporations for federal income tax purposes. Such classification was justified in our analysis by considerations of administrative complexity, competitive fairness, and the ultimate integrity of the corporate income tax base.

The tentative judgment offered in our 1986 testimony regarding the near-term prospects for significant integration of the corporate and individual income tax systems has been confirmed by subsequent events. The Tax Reform Act did not adopt any of the integration provisions contained in earlier tax reform proposals, and in important respects actually reinforced the effect of the separate corporate income tax. It thus remains appropriate to consider the proper tax treatment of MLPs in the context of an income tax system that permits single level taxation for some business entities but requires double level taxation for others.

The significance of the Tax Reform Act with respect to the proper taxation of MLPs extends well beyond the issue of corporate integration. The Act made fundamental changes in the tax system that significantly affect the taxation of corporate and noncorporate entities and hence the relative attractiveness of the MLP form of organization. At the same time, the market for exchange-traded MLPs, which dates back only to 1981, has continued to evolve. In particular, the last twelve months have seen rapid growth in the total assets held by MLPs and the diversity of activities carried on in MLP form.

My testimony today will examine the proper tax treatment of MLPs in light of recent changes in the tax law and commercial markets. I will first analyze the changes made by the Tax Reform Act and the effect of these changes on the business decision whether to operate in corporate or noncorporate form. I will next review existing uses of the MLP form, with an emphasis on possible emerging trends. Finally, I will discuss our views regarding the appropriate tax treatment of MLPs in light of their current and possible future characteristics. In general, our conclusion restates the suggestion in our 1986 testimony that Congress may wish to consider classifying MLPs as associations taxable as corporations. In offering this suggestion, we recognize the need for appropriate transition relief for existing MLPs and suggest consideration of a special statutory pass-through vehicle for natural resource development activities.

I. Tax Reform Act Changes Affecting MLPs

A. Description of Changes

Basic Rules. Although the income or loss of a partnership is calculated at the entity level, no entity level tax is imposed. Instead, the items of partnership income, gain, loss, deduction, and credit are passed through to the partners, retaining their character in the hands of the partners.3/ Partnership income is taxed to the partners whether or not the partnership distributes the income and partnership losses can be deducted by the partners, subject to certain limitations.

In contrast to the pass-through taxation of partnerships, the income of corporations generally is subject to two levels of taxation.4/ The corporation is taxed as a separate entity when the income is earned and its shareholders are subject to an additional tax when they receive distributions of income or sell

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3/ The activities of a partnership are, in effect, imputed to the partners, with all partnership items treated as incurred directly by the partners. For example, if the partnership engages in an active trade or business, the distributive share of the income of a tax-exempt partner generally is treated as unrelated business taxable income. Similarly, if the partnership conducts a trade or business in the United States, the distributive share of income of a nonresident alien partner is treated as income effectively connected with a trade or business conducted in the United States.

4/ Certain corporations are afforded relief from the so-called "classical" two-level tax structure through the allowance of a dividends paid deduction or other form of integration of the corporate and individual tax systems (*e.g.*, real estate investment trusts ("REITs"), regulated investment companies ("RICs"), real estate mortgage investment conduits ("REMICs"), and S corporations).

or exchange their shares at a gain. In general, the losses of a corporation can be utilized only to offset the past or future income of the corporation.5/

The Tax Reform Act did not significantly alter the basic rules under which the income of partnerships and corporations is subject to tax. As indicated above, the issue of corporate integration was raised during the tax reform process and various proposals to provide partial relief from the separate corporate income tax were directly considered by Congress.6/ Ultimately, however, these proposals were not adopted, leaving intact the classical two-level tax system for corporate income.

Tax Rates. Prior to the Tax Reform Act, the maximum statutory tax rate on individual income, including an individual's share of partnership income, was 50 percent (20 percent for long-term capital gains), while the maximum statutory corporate income tax rate was 46 percent (28 percent for long-term capital gains). Taking account of shareholder level taxes, the maximum combined rate of tax on currently distributed corporate income was 73 percent.7/

The dramatic lowering of maximum tax rates by the Tax Reform Act, to 28 percent for individuals and 34 percent for corporations, has resulted in a maximum corporate rate that exceeds the maximum individual rate for the first time since

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5/ To the extent the corporation's losses are reflected in the value of its stock, and result in the realization of a loss upon the sale of the shares, the shareholder's loss can be used to offset other capital gains.

6/ Proposals to integrate partially the corporate and individual income tax systems through the allowance of a dividends paid deduction were included in the Treasury Department's November 1984 report to the President on tax reform (which proposed a 50 percent dividends paid deduction, to be phased in over a six year period), the President's May 1985 tax reform proposals to the Congress (which proposed a ten percent dividends paid deduction, effective immediately), and the tax reform bill originally passed by the House of Representatives (which contained a ten percent dividends paid deduction, to be phased in over a ten year period).

7/ The combined tax rate of 73 percent is equal to the sum of: (a) the 46 percent corporate tax rate and (b) the 50 percent individual tax rate times the 54 percent of corporate income available for distribution after payment of the corporate tax.

1913. Under the Act, the maximum combined tax rate on currently distributed corporate income will be 52.48 percent.[8] The Act also repealed the preferential tax rate on capital gains, so that individual and corporate capital gains will be subject to tax at maximum rates of 28 and 34 percent, respectively.

Taxation of Contributions, Distributions, and Major Capital Transactions. The Tax Reform Act did not alter the basic rule that contributions or distributions of assets to or from a partnership are generally nontaxable events. Consequently, the formation or in-kind liquidation of a partnership generally remains nontaxable.

Contributions to and acquisitions by corporations are nontaxable events only if certain conditions are satisfied.[9] Corporate distributions generally are taxable to the shareholders as ordinary income to the extent of the earnings and profits of the corporation. Distributions in redemption of a shareholder's stock may be taxable as ordinary distributions or as proceeds from a sale of the stock, depending on the effect of the transaction on the shareholder's ownership interest in the corporation.

In general, corporations are subject to tax on the sale or distribution of appreciated property. Prior to the Tax Reform Act, this rule was subject to exceptions that significantly limited its effect. In particular, under the so-called General Utilities doctrine, sales or distributions as part of the complete liquidation of a corporation generally were exempt from corporate level tax. The Tax Reform Act eliminated the General

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[8] The combined tax rate of 52.48 percent is equal to the sum of: (a) the 34 percent corporate tax rate and (b) the 28 percent individual tax rate times the 66 percent of corporate income available for distribution after payment of the corporate tax.

[9] Generally, gain or loss is recognized to a shareholder on the contribution of property to a corporation in exchange for stock or securities of the corporation unless such shareholder and any other contributors control the corporation immediately after the exchange. In addition, other acquisitions may be taxable events unless the detailed requirements of the corporate reorganization provisions are satisfied.

Utilities doctrine so that appreciation on corporate assets, as with other corporate income, is now subject to double level tax.10/

Partnership Losses. The Tax Reform Act added rules restricting the current deduction of losses from passive activities, generally including a limited partner's share of partnership losses. In particular, prior to the disposition of a passive activity, losses from the activity may not be used to offset income from nonpassive activities, including salary income and portfolio income, such as interest, dividends, or royalties. Losses from a passive activity remain currently deductible, however, against income from passive activities, generally including a limited partner's share of partnership income.11/

B. Effects of the Changes Made by the Tax Reform Act

Changes in Tax Rates and Base. As described above, the Tax Reform Act dramatically lowered the maximum statutory rates of tax applicable to corporate and partnership income. The effect of these rate reductions is difficult to determine, however, since the effective, rather than the statutory, tax rate on a partnership's or corporation's income varies with its particular activities. Thus, tax incentives in the form of credits or cost recovery deductions have substantially offset statutory tax rates on the income from certain assets. Moreover, a number of factors have tended to protect corporate income from full double taxation, including: (i) issuance of debt, which generates deductible interest; (ii) retention rather than current distribution of corporate earnings, which may defer, eliminate, or, prior to the Tax Reform Act, result in a preferential capital gain rate for the shareholder level tax; and (iii) liquidating distribution or sale of appreciated assets, which, prior to the Tax Reform Act, exempted the appreciation from corporate level tax.

10/ Corporate level nonrecognition on liquidating distributions is preserved for liquidations of certain controlled subsidiaries. Since the parent corporation also inherits the subsidiary's tax basis in its assets, appreciation in the assets is preserved for future corporate level tax upon a sale or distribution by the parent.

11/ The general rule that income from a limited partnership is passive income is subject to exceptions. For example, a partnership's portfolio income retains such character in the hands of the partners. In addition, under section 469(k)(3), the Treasury Department has regulatory authority to provide that income from certain passive activities is not treated as passive income.

Since business entities differ widely in the nature of their activities, their level of debt capitalization, the extent to which they distribute or retain earnings, and the degree to which they hold appreciated assets, the effect of tax reform on the relative attractiveness of the partnership form is not uniform. Although it is therefore difficult to make general observations, we think an appropriate measure of the relative tax advantage of partnerships over corporations before and after tax reform may be obtained by comparing the after-tax rate of return to an investor for the two forms of business organization, assuming that the asset mix and financial structure of the enterprise is independent of the nature of the entity.

Table 1 shows (for both pre- and post-Tax Reform Act law) the percentage increase in the after-tax rate of return that may be realized on the listed investment if such investment is made in partnership rather than corporate form. In addition, the table lists the overall percentage increase in after-tax return for the typical mix of corporate investment. As the table illustrates, when only taxes are considered, partnerships are more attractive than corporations for all types of new investment under both pre- and post-Tax Reform Act law. Moreover, the table shows that the Tax Reform Act significantly increased the incentive to conduct business in partnership form. Overall, under prior law, partnership investment would have yielded the investor an after-tax rate of return 10.8 percent higher than earned on the same mix of investments undertaken in corporate form. The Act increased this percentage difference to 21.7 percent, thereby doubling the investor's incentive to operate in noncorporate form.

A more concrete indication of the effect of the Tax Reform Act on the incentives to operate in corporate or pass-through form is given by the number of corporations that have elected to be taxed under the pass-through rules of subchapter S. Between January 1 and June 30 (the heaviest filing period for S elections), S elections numbered approximately 147,000 in 1983, 187,000 in 1984, 133,000 in 1985, and 174,000 in 1986. By contrast, 329,000 S elections were filed between January 1 and May 30, 1987.

Other Considerations. The analysis above of relative incentives for operating in partnership or corporate form does not take account of the new passive loss rules adopted in the Tax Reform Act. To the extent that the income from MLPs is characterized as passive income under these rules, an investor in an MLP would be able to offset his share of partnership operating income and any gain recognized on the sale of the partnership interest against passive losses that otherwise might not be currently deductible. Since income from an investment in a public corporation would generally not be passive income, characterization of MLP income as passive could significantly increase the relative attractiveness of MLPs over corporations. On the other hand, to the extent that MLPs generate losses, the addition of the passive loss rules limiting current use of those losses reduces the attractiveness of MLPs.

In addition, our analysis of relative incentives does not reflect the impact of the corporate alternative minimum tax adopted in the Tax Reform Act. The provisions of the corporate minimum tax, in particular, the book income preference, would further increase the incentives favoring the partnership form of organization.

II. Existing MLPs and Future Trends

A. Background

Existing MLPs generally fall into one of four categories, based on their method of formation: (i) "roll-up MLPs," formed by the combination of two or more partnerships into one publicly traded partnership; (ii) "liquidation MLPs," formed by a complete liquidation of a corporation into an MLP; (iii) "acquisition MLPs," formed by an offering of MLP interests to the public, with the proceeds used to purchase assets; or (iv) "roll-out MLPs," formed by a corporation's contribution of operating assets in exchange for general and limited partnership interests in the MLP, followed by a public offering of limited partnership interests by the corporation or the MLP, or both. A fifth category of MLP, that may well predominate in the future, is the "start-up MLP," formed by a partnership that is initially privately held but later offers its interests to the public in order to finance internal growth.

All MLPs employ accounting conventions to simplify application of the partnership tax rules and maintain the interchangeability of the limited partnership interests.12/

12/ To facilitate the trading of interests in an MLP, the limited partnership interests are typically deposited with a bank, or other depository, and depository receipts are issued in registered form representing such interests. The depository receipts are listed and traded, usually on one of the major exchanges instead of the over-the-counter market to avoid the necessity of complying with state blue sky laws. Assignees of these depository receipts are treated as limited partners for federal income tax purposes regardless of whether an (cont.)

Certain of these conventions, although not adopted for a tax avoidance purpose, are inconsistent with the statute and/or regulations. First, MLPs have adopted their own methods (inconsistent with the applicable regulations under section 755) of allocating adjustments to the basis of MLP assets. Moreover, to the extent that the basis of depreciable assets is adjusted, MLPs treat the adjustment as recoverable under the rules applicable when the asset was placed in service by the partnership rather than when the adjustment is made. In addition, where an MLP is formed through the contribution of several partners, as in a roll-up MLP, MLPs typically assume, for purposes of section 704(c), that the gain or loss inherent in each contributed asset is allocated in accordance with each partner's interest in the partnership. Finally, MLPs use "curative allocations" of income or loss to offset the differences in tax characteristics among partnership interests that result from the application of sections 704(b) and 704(c).

MLPs have adopted other "simplifying assumptions" regarding the application of the substantive rules of subchapter K. Among these assumptions are monthly or bimonthly conventions regarding the identification of the partners and conventions regarding the sales price of traded units. The monthly convention, for example, typically assumes that the partners owning units on the last day of the month have owned the units for the entire month. Further, it appears that in certain circumstances, MLPs are making adjustments in the basis of their assets under section 743(b) and section 754 that may be inappropriate.13/

B. Existing MLPs

According to our information, at present there are approximately 126 exchange-traded MLPs in existence or in the process of formation. Table 2 shows the number of exchange-traded MLPs by type of formation, year of formation, and nature of activity. As shown in Table 2, 3 MLPs were formed in 1981, 5 in 1982, 6 in 1983, 6 in 1984, 28 in 1985, and 38 in 1986

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assignee is formally substituted as a limited partner. Further, to limit the administrative burden of trading, MLPs permit purchasers of interests to hold such interests in nominee accounts provided that the nominee files an application to become a substitute limited partner. As a result, many investors hold their interests in a "street name."

13/ Certain MLPs, relying on analogous authority under section 351, have increased the basis of partnership assets for the premium paid to an underwriter for the units in a firm commitment underwriting. Section 709 prohibits a partnership from deducting or amortizing syndication fees.

(21 formed after September 1986).14/ A summary of financial statistics from the 1985 tax returns of certain exchange-traded MLPs is attached as Appendix A. During 1986, $3.2 billion in MLP interests were offered to the public, compared to $61.8 billion in new stock issues by corporations in the same year.15/ At least 40 MLPs are currently in the formation process or have been formed in 1987. As Table 2 indicates, more than two-thirds of the existing or pending MLPs are engaged in the oil and gas or real estate business.16/ As illustrated in Table 2, however, many of the more recently formed or proposed MLPs are engaged in a much broader spectrum of business activities. For example, of the 61 MLPs formed or in the process of formation since the passage of the Tax Reform Act, only 22 are in the oil and gas or real estate business while 39 are in other industries.

As noted in Table 2, excluding some of the transactions that are in registration, there are 20 roll-up MLPs, 23 liquidation MLPs, 29 roll-out MLPs, and 45 acquisition MLPs. Virtually all of the roll-ups and many of the roll-outs occurred in the oil and gas industry, whereas acquisitions and to a lesser extent liquidations have been used more frequently in real estate and other industries.

14/ The transition rules for the repeal of the General Utilities doctrine permitted corporations that completely liquidated before January 1, 1987 to avoid full recognition of corporate level gain as under prior law. This provision provided a significant incentive for the formation of liquidation MLPs prior to January 1, 1987.

15/ For the same period, there were $134.1 billion in corporate stock repurchases and $46.2 billion in corporate retained earnings.

16/ The statutory rules applicable to REITs provide a special pass-through regime for real estate investment. Unlike MLPs, REITs are subject to restrictions limiting them to passive investment activities, must currently distribute substantially all of their income, and cannot pass through losses to investors. Many real estate MLPs engage in development and management activities barred to REITs. In amending the REIT rules in the Tax Reform Act, Congress carefully considered the issue of what activities REITs should be permitted to engage in without becoming subject to corporate level tax. To the extent the Tax Reform Act provisions identified Congress' intended scope of pass-through treatment for publicly held real estate entities, the existence of real estate MLPs whose activities are unrestricted is anomalous.

The use of partnerships and joint ventures to conduct oil and gas ventures has been very common, and thus some of the growth in the number of MLPs in this industry may continue to arise through the formation of roll-up MLPs. Most oil and gas and timber MLPs created by the transfer of assets out of corporate solution have involved only the interests in the natural resource properties of such corporations, and not their "downstream" operations such as milling, processing, refining, or marketing activities.

As described in Table 2, however, the MLP form has been used for a variety of different businesses. Among the businesses utilizing the MLP form most recently are sports franchises, cable television businesses, gas pipelines, motion picture businesses, hotel and motel chains, health care businesses, restaurant chains, and home building companies. At the June 1986 hearings before the House Select Revenue Measures Subcommittee, several witnesses testifying in support of the continued classification of MLPs as partnerships suggested that the development of MLPs would not result in a significant erosion of the corporate tax base, ~~because~~ the MLP form is not suitable for active businesses. Others suggested that the MLP sector "consist[s] of passive assets that are basically pools of passive investment dollars that pay out a current yield."17/ As illustrated by the above figures, however, the market has evolved considerably since 1981, and is no longer limited to MLPs holding passive assets. Indeed, several of the more recent actual and proposed transactions illustrate the significant flexibility of the MLP form.

In early 1987, a professional sports team, operating in corporate form, filed a preliminary prospectus offering to the public over $20,000,000 of MLP interests.18/ The MLP would succeed to the assets and liabilities of the corporation, which would be the general partner and would also hold approximately 60 percent of the limited partnership interests. The proceeds of the public offering would be used to retire indebtedness incurred by the corporation in connection with the prior acquisition of the business and to fund certain construction costs and the working capital needs of the MLP. The business of the MLP would be to own and operate a professional sports franchise and to promote a municipally-owned multi-purpose sports and entertainment facility. The franchise operations include the sale of tickets and the licensing of television, cable television, and radio broadcast rights. The MLP would also share in the arena's food, beverage, merchandise, and parking revenues.

17/ Statement of William S. McKee, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Hearing on Issues Relating to Pass-Through Entities, June 9, 1986. See also, statements of Barksdale Hortenstine and Mark A. Kuller.

18/ This transaction would involve the second conversion of a professional sports franchise to MLP form.

A recent MLP formed by the liquidation of a corporation is engaged in the home building business. This MLP has itself acquired a substantially larger home building corporation in a two-stage leveraged buy-out. The first stage consisted of the MLP's formation of two acquisition corporations that each made cash tender offers for a portion of the target corporation's shares. The funding for the tender offers was provided almost exclusively by bank loans and the issuance of debt securities. Following the acquisition of sufficient shares to control the target, the MLP caused the acquisition corporations jointly to form a subsidiary which was merged into the target corporation. In the merger, the remaining target shareholders received cash and MLP interests.

In addition to the participation of MLPs in leveraged buy-outs, MLPs also have been used following such acquisitions. For example, in February 1987, the business of a corporation that had been acquired in a leveraged buy-out was converted to partnership form. This was accomplished by having the acquired corporation contribute its business (the wholesale distribution of industrial products) to a partnership in exchange for a $100 million note and $100 million of partnership interests. These partnership interests were then sold by the corporation to the public and the MLP issued $110 million in notes to the public, using the funds to retire its debt to the sponsor. Presumably, the sponsor used the proceeds of the sale of the partnership interests and the repayment of its loan to the partnership to retire its acquisition indebtedness. The prospectus for this MLP represents that cash distributions on the partnership interests (other than a class of partnership interests analogous to preferred stock) will be approximately equal to the tax liability of the partners with respect to the MLP's taxable income from the previous year.19/

MLPs have been organized to conduct a variety of other businesses. For example, in December 1986, a corporation operating over 50 long-term health care centers (over 6,500 beds) and over 20 home health care programs, liquidated into an MLP. The MLP has approximately 6,000 employees. The prospectus states that the MLP's cash distribution policy following this conversion will be to distribute annually to the partners an amount equal to the tax savings from doing business in partnership form.

Another MLP was formed earlier this year by the roll-out of the liquefied petroleum gas processing, transportation, storage, and distribution business of the corporate sponsor. The MLP has

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19/ The same policy with respect to distributions was announced by an MLP created in January of this year to engage in the motion picture business.

approximately 3,500 employees. The sponsor retained approximately 40 percent of the interests in the partnership. As part of the formation, the MLP assumed approximately $130 million in debt, representing about 25 percent of the value of the business. The MLP intends to distribute all of its net cash flow and to finance acquisitions through borrowings and the sale of additional interests in the partnership. Another similar transaction, considered in March 1987, would involve the purchase of a natural gas pipeline by an MLP from the corporate sponsor. Thirty percent of the purchase price paid by the MLP would be funded by the offering of MLP interests and 70 percent would be funded by the offering of debt.

Several trends can be discerned from the recent actual and proposed transactions involving MLPs. First, the MLP form is not limited to the passive ownership of wasting assets, such as oil and gas and other natural resources, but is increasingly used by active business enterprises. Second, the MLP form is not limited to businesses that distribute substantially all of their income. Several recent MLPs plan to reinvest most of their earnings and distribute only those amounts necessary to pay partner tax liabilities. Third, MLPs can be capitalized in large part by debt. It has been suggested that the inability of tax-exempt investors to acquire MLP equity without generating unrelated business income will deny MLPs a large source of capital, thereby limiting their growth. Tax-exempt investors can, however, invest in MLP debt without generating unrelated business income.

As the marketplace continues to adjust to the operation of businesses in partnership form, we believe the MLP structure will become more common among existing businesses. More importantly, given the substantial incentive to operate in noncorporate form under current law, the use of the partnership form for new business ventures may become the norm rather than the exception. Whether these new businesses are formed initially as MLPs or instead as smaller partnerships that later become MLPs, the number of new businesses in MLP form may be expected to increase rapidly.

III. Policy Considerations

A. Advantages of the MLP Form

Proponents of MLPs often explain that the use of MLPs is driven largely by nontax considerations. For example, it has been stated that the use of the partnership form permits the raising of capital without incurring debt, permits a corporation to highlight the value of assets that otherwise would be undervalued by the market, and encourages more efficient management and investment practices by encouraging the distribution rather than retention of earnings. Without questioning that MLPs may offer the above advantages, it is important to recognize that such advantages are, in fact, grounded in the differences in tax treatment between partnerships and corporations. Use of the MLP form may substitute for the issuance of additional corporate debt, but only because the partnership form offers the same tax advantage -- avoidance of entity level tax -- as corporate debt. An MLP may enable a corporation to highlight undervalued assets, but the same purpose would be equally served by a corporate subsidiary save for the difference in tax treatment. MLPs are more likely than corporations to distribute earnings currently, but only because corporate distributions trigger a second level of tax. Thus, although MLPs may offer nontax advantages, these advantages are attributable to an MLPs tax rather than nontax characteristics. To put the point in other terms, we believe it evident that the MLP form would not be used to any significant extent if MLPs were taxed in the same manner as corporations.

B. Ad Hoc Integration

What the stated nontax advantages of MLPs illustrate is that partnership classification for MLPs offers certain of the advantages associated with direct proposals to eliminate, or at least reduce, the corporate income tax. Thus, the inefficiencies attributable to the separate corporate tax, such as the incentives it creates for excessive debt capitalization or retention of earnings, will be relieved to a greater or lesser extent by any proposal that effectively reduces the burden of that tax. Formal proposals for integration of the corporate and individual income taxes have attempted to provide that relief in a systematic manner that extends across the corporate sector. In contrast, the use of MLPs is limited by a variety of circumstances unrelated to the burden of the corporate tax. Although start-up businesses may have broad access to MLPs,20/ their use by an existing corporation generally requires a

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20/ The use of MLPs by start-up businesses may currently be limited by market perceptions of MLPs as high-yield investments. Such perceptions, however, are likely to be transitory. As described above, MLPs have increasingly been formed to carry on active businesses, with an announced policy to distribute earnings only as necessary to satisfy the partners' tax liabilities.

transfer of assets to an MLP. A corporation's ability to transfer assets will depend on such factors as the tax and nontax cost of the transaction, as well as the severability of the transferred assets from the rest of the corporation's activities. Finally, the substantial costs of forming and operating an MLP and the variations in such costs among different industries may make it more burdensome for certain publicly traded entities, particularly those that are relatively small, to take advantage of the MLP form.

If MLPs retain pass-through treatment, public corporations unable to convert in whole or in part to MLP form will remain subject to double taxation, while competitors of similar size and accessing the same capital markets will receive pass-through treatment. Those businesses trapped in corporate form will be disadvantaged in pricing their goods and services and in attracting new equity capital as against MLP competitors. We believe such distinctions to be inappropriate and that MLPs, as an approach to corporate integration, raise basic questions of fairness.

C. Administrative Considerations

Utilization of the partnership model of taxation for business entities, the interests in which are widely held and frequently transferred, creates difficult accounting and tax collection issues, with attendant compliance and enforcement problems for the Internal Revenue Service ("IRS") and the entities themselves. It is principally for this reason that partnership model integration of the corporate and individual taxes has been rejected, both by those countries providing integrated corporate tax systems, and by the United States in providing integrated systems for special purpose entities such as RICs and REITs.

As described earlier in this testimony, existing MLPs employ a number of simplifying assumptions in order to account for the entity's operations under the rules of subchapter K. Although such assumptions may make the tax accounting problems of MLPs relatively manageable, we are concerned that they result in possibly significant inaccuracies. Moreover, we are concerned about whether the IRS can verify their accuracy through the audit process, and enforce liabilities where inaccuracies are discovered.

One of the historical justifications for a separate corporate level tax is the difficulty in accounting for a widely held business's activities under a pure pass-through model. The administrative difficulties of a pass-through model for MLPs, however, could be addressed by measures short of taxing MLPs as corporations. For example, the constructive termination rules of section 708(b) could be revised or eliminated with respect to MLPs. Methods currently used by MLPs to approximate income allocations and basis adjustments could be expressly sanctioned. More significantly, enforcement and collection difficulties could be minimized by imposing a withholding tax on MLPs and collecting any tax deficiencies from the MLP (thereby forcing the current partners, rather than the partners in the year to which the deficiency relates, to bear the burden of the additional tax).

Adoption of the above measures would substantially reduce the administrative difficulties in taxing MLPs. The need for such measures, however, is a substantial indication that MLPs do not possess requisite partnership characteristics. Ultimately, the significance of the administrative problems of MLPs is not that the problems are insoluble, but that their solution requires movement away from the traditional partnership model and in the direction of a new, hybrid pass-through entity, possessing additional corporate characteristics.

There is no precedent for a special statutory pass-through entity unrestricted in its size or activities. Moreover, the arguments that might support creation of such an entity do not differ in kind from the arguments that generally support integration of the corporate and individual income tax systems.

D. The Corporate Tax Base

Our review of the existing market for MLPs indicates that an increasingly diverse array of business activities are conducted in MLP form. Although the total capital investment in MLPs remains relatively small, the growth in MLP utilization has been rapid. If MLPs retain pass-through treatment, we expect rapid growth to continue. We recognize that the tax incentives for large, publicly held businesses to operate in MLP form may be offset by tax and other costs involved in forming and operating an MLP. Increasingly, however, the tax law will cause businesses entering the public capital markets to utilize the MLP rather than corporate form.

As I have previously stated, MLPs achieve a form of integration and, in this respect, serve certain of the tax policy principles that generally support integration of the corporate and individual income tax systems. Significant movement toward integration, however, should be based on deliberate policy choices rather than self-help actions that strain the boundaries of existing pass-through vehicles. In part, this reflects the administrative and fairness concerns discussed earlier in this testimony. More fundamentally, however, we are concerned that expansion in the use of MLPs could erode the corporate tax base.

The general rate reductions accomplished in tax reform required a substantial increase in revenues from the corporate sector. Moreover, although the legislative record need not be read to indicate a rejection of corporate integration in principle, many of the changes in the Tax Reform Act reflected a public and political judgment that the relative tax burden on corporations should be increased. If such judgments are to be overturned, it should result from the considered action of the political system rather than private innovation in the uses of pass-through entities.

Attached to my testimony are estimates of the revenue consequences of classifying MLPs as corporations for tax purposes. As the estimates indicate, classification of MLPs as corporations would have only modest revenue effects over the budget period. The long-term effect of a change in classification may be different, however, as suggested by the steadily increasing revenue effects over the budget period.

E. Transition Issues

A change in the classification of MLPs for tax purposes would require development of appropriate transition rules for existing MLPs. These rules could take a number of forms, such as "grandfathering" of partnership status for a fixed time period. In any event, we believe it important that existing MLPs formed in reliance on the provisions of current law be provided adequate time to adjust or resolve their activities before being subjected to the corporate income tax.

F. Possible Statutory Exceptions

In conjunction with any change in the classification of MLPs for tax purposes, we believe consideration should be given to continued authorization of pass-through treatment of publicly traded entities providing direct investment opportunities in activities traditionally conducted in noncorporate form. Thus, application of a separate corporate tax may be inappropriate where a business entity serves principally to hold relatively passive assets and distribute the income to its owners.

Under current law, a similar rationale has supported pass-through treatment for publicly traded entities organized as REITs, RICs, and, more recently, REMICs. Although these statutory pass-through vehicles provide investors with liquidity and diversification, they effectively preserve the regime of taxation traditionally faced by investors in real estate, corporate securities, and real estate mortgages.

If Congress changes the classification of MLPs for tax purposes, we suggest that it consider extending the current statutory pass-through models to include activities such as natural resource development. Thus, as with REITs, RICs, and REMICs, entities engaged principally in developing timber, coal, oil and gas, and other natural resources serve a relatively passive function, generating income from wasting assets and distributing it to investors. Given the importance of natural resource development to the nation's security, Congress should consider carefully whether such traditionally noncorporate activities should be subjected to corporate level tax.

IV. Conclusion

In conclusion, our review of the changes in the tax law and commercial markets over the past year causes us to restate the suggestion in our June 1986 testimony that Congress consider classifying MLPs as corporations for tax purposes. We make this suggestion without qualifying our historical support for the concept of integrating the corporate and individual income tax systems. In our judgment, however, although MLPs mitigate the corporate income tax, and thus share some of the virtues of formal integration proposals, they provide relief that is both complex administratively and unavailable to many businesses subject to the corporate tax. If significant relief from the burden of the separate corporate income tax is to be provided, it should be the result of a deliberate process, which assures that the relief is provided in a manner that is administrable, fair, and fiscally responsible.

We regard this suggestion as consistent with the philosophy underlying tax reform in that the expected revenue from the corporate sector would thereby be protected. Thus, the proposal is properly viewed as essentially revenue-protecting rather than revenue-enhancing and would not reopen issues resolved in tax reform.

There would be some logic in Congress delaying full consideration of this issue until the Treasury Department completes its study of Subchapter C of the Code. The Tax Reform Act required the Treasury Department to submit this study to Congress by January 1, 1988. We expect that the study will consider a wide range of corporate issues, which may establish a broader framework for considering the tax treatment of MLPs.

Defining a publicly traded partnership may be difficult. Interests in many partnerships that are not traded on organized exchanges can be sold through a number of firms, although the market for any individual partnership interest may be rather thin. In addition, major investment brokerage houses typically undertake to make a market in their partnership offerings, either in their role as broker or as a general partner. As a result, restricting the definition of publicly traded partnerships only to those whose interests are traded on an organized exchange may be too narrow. On the other hand, treating publicly offered, but not publicly traded, limited partnerships as corporations would seem inappropriate, since these entities do not presently raise the same level of concern. If the Subcommittee decides to undertake an effort to revise the classification rules, we are of course willing to work with it and the Congress to develop an acceptable definition of those partnerships whose interests may be viewed as publicly traded.

In sum, the Treasury Department believes that the considerations raised in our testimony of June 1986 remain basically sound. In view of concerns about possible adverse effects of changes in the classification of MLPs on activities traditionally conducted in partnership form, however, the Administration still has the issue under review.

This concludes my prepared remarks. I would be pleased to answer any questions.

Table 1

Percentage Increase in the After-Tax Rate of Return to an Investor Conducting Business in Partnership Rather Than Corporate Form 1/

Asset	Relative After-Tax Return 2/	
	Prior Law	TRA
Equipment	6.9	18.7
Structures	10.0	22.6
Inventory	15.6	23.7
Land	15.6	23.7
Overall	10.8	21.7

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1/ Calculations assume a real 8 percent pre-tax return on all investments, a 4 percent inflation rate, and include the effects of cost recovery allowances and statutory income tax rates at the Federal and state levels. Financing is two-thirds equity and one-third debt. Most of the return to corporate equity (93 percent) is taxed as a capital gain, with the remainder (7 percent) of the return to corporate equity taxed as a dividend.

2/ Difference between the noncorporate after-tax return and the corporate after-tax return, expressed as a percentage of the corporate after-tax return.

Table 2

Number of Exchange Traded MLPs by Year of Formation, Method of Formation, and Nature of Activity

Year/Nature	Roll-Up	Liquidation	Roll-Out	Acquisition	Unknown	Total
1981						
Oil and Gas		1	1			2
Real Estate		1				1
Subtotal		2	1			3
1982						
Oil and Gas	3		1			4
Timber		1				1
Subtotal	3	1	1			5
1983						
Oil and Gas	1	1	1			3
Real Estate		1		2		3
Subtotal	1	2	1	2		6
1984						
Oil and Gas	3		1			4
Real Estate	1			1		2
Subtotal	4		1	1		6
1985						
Oil and Gas	9	2	7			18
Timber	1	3				4
Real Estate		2		4		6
Subtotal	10	7	7	4		28
1986						
Oil and Gas	2		2			4
Real Estate		5	2	8		15
Motels/Restaurants		2	1	4		7
Cable TV			1	1		2
Other		4		6		10
Subtotal	2	11	6	19		38
1987 (through 6/29/87)						
Oil and Gas			1	2		3
Real Estate	1	2	2	4	4	13
Motels/Restaurants			1	4	1	6
Cable TV				2	2	4
Other		1	5	6	4	16
Subtotal	1	3	9	18	9	40
Totals (through 6/29/87)	21	26	26	44	9	126

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Table 3
Revenue Estimates for Proposals Affecting Publicly Offered Limited Partnerships
(in millions of dollars)[1]

Entities Affected	Include Existing Entities						Exclude Existing Entities					
	1988	1989	1990	1991	1992	1988-92	1988	1989	1990	1991	1992	1988-92
Tax as Corporations												
MLPs only[2]												
Natural Resource	42	74	82	90	99	387	2	5	9	13	19	47
Other Industries	84	170	225	290	368	1,137	22	64	114	173	245	618
Total	126	244	306	380	467	1,524	24	69	122	186	264	665
All Publicly Offered												
Natural Resource	171	302	332	366	403	1,574	8	23	40	58	80	209
Other Industries	499	977	1,236	1,526	1,850	6,088	112	312	538	792	1,080	2,833
Total	670	1,279	1,569	1,892	2,253	7,662	120	335	577	851	1,160	3,042
Treat Income as Portfolio Income												
MLPs only[2]												
Natural Resource	16	29	31	35	38	149	1	2	3	5	7	19
Other Industries	32	65	86	112	142	438	9	25	44	68	96	241
Total	48	94	118	146	180	586	9	27	48	73	103	260
All Publicly Offered												
Natural Resource	76	135	149	163	179	103	4	10	17	25	34	91
Other Industries	250	489	618	763	925	3,044	56	156	269	396	540	1,417
Total	326	624	767	926	1,104	3,747	59	166	286	422	574	1,508

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[1] Difference between the tax revenues estimated to be collected under the policy change noted and the estimated tax revenues for a base case which assumes that the authority to treat passive income as portfolio income is not exercised.

[2] MLPs refer to publicly offered limited partnerships whose interests are traded on an organized exchange.

APPENDIX

1985 Financial Characteristics of MLPs

Appendix Table 1 provides a comparison of the financial characteristics of the average exchange-traded MLP with those of the average limited partnership, as obtained from available 1985 partnership tax returns. The information is of limited relevance, however, since MLPs now engage in a much wider range of activities, and because the current tax law restricts a taxpayer's ability to use losses generated by limited partnerships to shelter other income.

Exchange traded MLPs account for a small fraction of the limited partnership sector. For example, total MLP assets in 1985 of about $15 billion represented only 2.5 percent of the more than $600 billion of assets in all limited partnerships. However, the table shows that the average MLP is approximately 100 times larger than the average limited partnership. MLPs on average showed positive partnership income (Form 1065 "ordinary income") of $15 million, compared to an average Form 1065 loss for all limited partnerships of about $100 thousand. Even among limited partnerships with Form 1065 gains, the average gain was only about $200 thousand. Similar differences may be noted for the average levels of debt and equity.

The income that actually flows through to the partners for tax purposes, however, differs substantially in some cases from the Form 1065 ordinary income. Ordinary income on the Form 1065 excludes expenses such as intangible drilling costs and oil and gas depletion, and certain types of income such as capital gains. Column 2 of the table adjusts for these items, and presents the average "partners' income" for the MLPs. (Corresponding information is not available to permit similar adjustments for all limited partnerships.) The table shows that the partners' income is substantially less than the Form 1065 ordinary income for MLPs in the oil and gas industry, but substantially larger than the Form 1065 ordinary income for those in the real estate and timber industries. (Several of the oil and gas MLPs were registered as tax shelters.) Indeed, while 16 oil and gas MLPs had positive Form 1065 ordinary income, only 10 had positive partners' income. Three of the real estate and timber firms had Form 1065 ordinary losses, but only one had negative partners' income.

Moreover, the taxable income generated by MLPs was low relative to the equity invested. The last column of the table reports the ratio of partners' income relative to the partners' equity. The overall average MLP showed a taxable return of 2.4 percent. The rates differed considerably by industry, with oil and gas MLPs showing only a 1.4 percent return, while the real estate and timber MLPs show a 5.8 percent taxable return. Finally, the table also shows that the level of debt incurred by MLPs was lower than that for all limited partnerships. The table shows that the 1985 debt/equity ratio for MLPs was .144, well below the average of 7.819 for all limited partnerships that year (and even below the .738 ratio for nonfinancial corporate business).

APPENDIX TABLE 1

AVERAGE FINANCIAL STATISTICS FOR LIMITED PARTNERSHIPS FROM 1985 PARTNERSHIP TAX RETURNS[1]

Type of Partnership	Ordinary Income[2]	Partners' Income[3]	Partners' Equity	Debt	Debt/ Equity	Partners' Income/ Equity
	(------Dollar Amounts in Millions			---------)	(-----Ratios	--------)
EXCHANGE TRADED MLPs:						
ALL INDUSTRIES	15.2	7.4	266.6	38.3	0.144	0.024
Gain MLPs[4]	21.5	9.1	305.5	40.1	0.131	0.026
Loss MLPs[4]	-5.2	1.8	140.3	32.6	0.233	0.011
OIL AND GAS	22.1	5.1	331.6	41.7	0.126	0.014
Gain MLPs[4]	30.1	9.5	426.6	52.1	0.122	0.020
Loss MLPs[4]	-3.7	-9.2	27.5	8.4	0.306	-.256
REAL ESTATE AND TIMBER	4.0	11.2	161.6	33.0	0.204	0.058
Gain MLPs[4]	7.6	8.5	111.6	21.0	0.188	0.064
Loss MLPs[4]	-7.9	20.2	328.2	73.0	0.222	0.050
ALL LIMITED PARTNERSHIPS:	-.1	NA	0.3	2.0	7.819	NA
Gain LPs[4]	0.2	NA	0.6	1.4	2.395	NA
Loss LPs[4]	-0.3	NA	0.1	2.4	45.150	NA

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1/ Of the 48 exchange traded MLPs in existence in 1985, tax information was readily available for 34. Of these, 26 had positive Form 1065 ordinary income, 8 had losses.

2/ Ordinary income as reported on the Form 1065 Partnership Return. This excludes certain types of income and expense such as capital gains and intangible drilling costs, which are reported on accompanying schedules.

3/ Partners' income equals ordinary income plus capital gains minus expenses such as intangible drilling costs, oil and gas depletion, and specially allocated items.

4/ MLPs with gain or loss in Form 1065 ordinary income.

AFTER RECESS

Senator **Baucus**. The subcommittee will come back to order.

Our next witnesses will be a panel consisting of Mr. John Neafsey, who is the Executive Vice President and Chief Financial Officer of the Sun Company; Mr. James Moffett, Chairman of the Board and Chief Executive Officer of Freeport McMoRan, Inc.; Mr. Lewis Sandler, General Partner and General Counsel for Southwest Realty, Limited; and Mr. Lawrence Cohen, First Vice President of VMS Realty Partners.

Gentlemen, we are happy to have you here, and why don't we begin first with Mr. Neafsey?

STATEMENT OF JOHN P. NEAFSEY, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, SUN COMPANY, INC., RADNOR, PA

Mr. **Neafsey**. Thank you very much, Senator, and it is a pleasure for me to be here as well. My name is Jack Neafsey. I am an Executive Vice President and Chief Financial Officer of the Sun Company, a large integrated domestic oil company.

What I would like to do this morning is to talk a little bit about the fundamental nature of the oil and gas business. It is an industry in which, I am sure you are aware, we must constantly generate its most important asset, its oil and gas reserves. It does this typically through the reinvestment of the cash flow that is generated from its production operations, and it reinvests this into new capital projects, thus generating its most important asset, its reserves.

In good years and in bad years, however, there are opportunities for the need for incremental capital. When times are good, we very often have an abundance of opportunities; and there is an opportunity, therefore, to raise new funds at the margin to fund that abundance of riches.

On the other hand, when times are bad—such as we experienced in 1986—sources of cash flow dry up from production; and it is necessary to supplement the cash flow which is generated internally with that from incremental investors. In those periods when external financing is required, there really are only three practical sources of raising that external financing: debt, equity—or common stock—and a hybrid vehicle, such as a master limited partnership, which is uniquely suited to the needs of the oil and gas business to the risk return characteristics of the oil and gas business.

Before I discuss each of those three alternatives, let me talk for a minute about the risk reward characteristics of this industry. There are really two types of risk that we have to deal with. The first is geological risk, and we have been dealing with geological risk for roughly 100 years. It is a statistical phenomenon; we know that roughly one in nine of every exploratory well that we drill, onshore domestically, is going to be a success; and the other eight are going to be dry holes, and we can handle that through the law of large numbers. So, the statistical risk associated with geology is one that we know and we can understand and we can handle.

But the second risk—the more pervasive risk—is price risk. Obviously, we had a dramatic experience with respect to price risk during the year 1986. We started the year when West Texas intermediate crude was selling at roughly $26 a barrel; we watched it plummet to below $10 a barrel by early August. It recovered to $15 a barrel, fell back to $13 a barrel; and it is currently selling for in excess of $22 a barrel. That is a roller coaster by anybody's definition, and it is a serious risk associated with new projects in this industry, which are very difficult to deal with.

If we take a look at price risk, that is a risk which cannot be accommodated by statistical phenomena, by the kind of structuring that normally takes place with geological risk; but it can be accommodated by hybrid financing vehicles, whereby the source of funds and the risks and rewards which are associated with the source of funds are matched to the risks and rewards associated with the fundamental nature of the business that you are pursuing.

You should never be borrowing money from a bank or from any other source of money through the debt capital markets in order to fund exploratory ventures, in order to fund high-risk ventures. That is an exercise that many of the banks in Texas and Oklahoma and Louisiana will give you a graphic lesson as to why that doesn't work; but from an incremental standpoint, the debt capital route is just simply one that should not be used for incremental projects.

Second, with respect to financing incremental projects using equity, you must understand that any time you are raising new money through the equity route, what you are doing is selling a portion of your existing reserves, a portion of your existing production and, therefore, unless you get a fair value for that equity—and obviously, during a time like 1985 or 1986 when the equity markets for oil and gas securities were depressed—you would be diluting your existing shareholders. So, at the margin, both the debt route is inappropriate; and the equity route is probably economically unfeasible.

And that causes companies such as ours to search for an alternative. Let me talk a little bit about our particular situation.

We issued $200 million worth of MLP units in December 1985. We did so at a time when neither the debt route nor the equity route looked appropriate to us. We promised the investor $2.90 in cash flow. That yielded an 11 percent rate of return to that investor. During the course of the year, as a result of the price gyrations, the actual return to the investor fell not to $2.90 but to $1.75. That illustrates the risk nature of the business and the risk nature of the security that was following it.

If we had done it with the debt route, we would have had a fixed payment to make to those investors. If we had done it through the equity route, we clearly would have had a severe amount of dilution; but using the MLP, the MLP structure was able to moderate and modulate, given the vigaries of the industry. The investor in his first year has become fully aware of the risks associated with an MLP. Hopefully, as we proceed in the future, he will learn a lot more about the rewards.

I would like to make a couple other points. First of all, with respect to this question of taxation, we still own 97 percent of those MLP units; and so, they continue to be taxed through the corporate form. If we were looking for a means of escaping corporate taxation, this is a terribly inefficient way to do it.

And finally, with respect to the whole question of changing the capital structure of American industry, this is a vehicle which works well at the margin. We are not talking about General Motors and we are not talking about DeLorean; we are talking about supplying incremental risk capital to a business which has fundamental risk/reward characteristics that are well suited to this type of financing. Thank you very much.

Senator BAUCUS. Thank you, Mr. Neafsey.

Our next witness is Mr. James Moffett.

[The prepared statement of Mr. Neafsey follows:]

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STATEMENT OF JOHN P. NEAFSEY BEFORE THE SENATE FINANCE COMMITTEE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT HEARINGS ON THE TAX TREATMENT OF MASTER LIMITED PARTNERSHIPS (MLPs)

JULY 21, 1987

Mr. Chairman and members of the committee, my name is John P. Neafsey. I am an Executive Vice President and the chief financial officer and a member of the board of Sun Company, an integrated energy company with operations primarily located in North America.

My testimony is intended to demonstrate that, in the case of Sun Company, the decision to form a master limited partnership was driven by a concern to realize full value of our energy producing assets and to raise new capital for reserve additions, not by a desire to avoid federal taxes. Changes in the Tax Reform Act of 1986 did not and will not materially affect our decisions with respect to our MLP. Certainly the changes in tax rates, the passive loss changes and numerous other provisions of the Tax Reform Act of 1986 have an impact on investor decisions and the entire area of capital formation. However, the decline in the price of crude and its resulting impact on the cash flow of our MLP units so overshadows tax reform as to make the consequences of reform almost imperceptible.

Future decisions by Congress to add an unanticipated tax burden to this type of capital formation would adversely affect current holders of MLP units as well as our decision to raise future capital by selling additional units.

FINANCIAL AND BUSINESS DECISIONS LEADING TO THE USE OF SUN'S MASTER LIMITED PARTNERSHIP

In December of 1985, Sun Company transferred all of its domestic oil and gas properties and related assets and liabilities to Sun Energy Partners, L.P., a master limited partnership. The properties consisted of approximately 8 million acres of which 2 million were developed, located in 37 states and in federal and state waters. In the same month, 2.7% of the partnership units were sold to the public at an initial offering price of approximately $200 million or $25 per unit. Based on estimated cash flows, and assuming a crude oil price of $24, Sun indicated in its prospectus the intention of distributing $2.90 per unit for 1986 and 1987.

To understand the primary motive behind Sun's use of the MLP it is necessary to look at the recent history of the oil industry especially from the viewpoint of a mid-size domestic company.

In the U.S. the success ratio for wildcat exploration has remained relatively constant at about 1 in 8. Companies like Sun had statistically compensated for this risk by participating in numerous exploratory wells thus permitting reasonable expectations of a 1 in 8 success ratio. Independents covered this risk primarily through the use of outside equity capital provided by investors with sufficient capital to underwrite the risk. Limited partnerships were often used as a vehicle to raise this capital.

By 1985, the slow decline in the real price of crude oil was negatively impacting the industry's drilling activities and the risk associated with adding new reserves. Sun's capital expenditures for exploration and production had significantly declined. It remained a primary objective for Sun to minimize the decline in its domestic oil and gas reserves and the MLP proved to be an efficient method to help in achieving this objective. It was well suited to the risks and rewards inherent in a business we saw becoming increasingly volatile. Debt instruments as a source of incremental capital were, in our opinion, an imprudent method of funding this higher risk exploration although a number of companies had chosen this route of financing. Finally, our common stock was selling at a price which made equity financing too expensive.

Adding to the risk were policy decisions made at the federal level. Sun had paid almost $1.8 billion in windfall profits tax since 1980 which drained capital from our exploration activity. In addition, federal leasing policy and state environmental restrictions were limiting the availability of more favorable exploration prospects thus adding to the risk of exploration.

Throughout the 80's, there was added to the physical risk of finding oil, the very real financial risk of being totally unable to predict what the oil may be worth. The price range for oil discovered in 1985 was estimated to be somewhere between $5 and $50, based primarily on the political decisions of a few Mideast countries.

In short, Sun Company needed risk capital and we considered it imprudent to borrow it and too expensive to raise it through equity. This concern was well founded in view of the precipitous drop in crude prices in early 1986. Let me assure the members of this Committee that at this point avoiding federal corporate income tax was not high on my list of priorities. The November, 1986 issue of Petroleum Management (p.17) includes an article describing, in industry terms, what Sun Company faced and continues to face with respect to financing the search for oil. One conclusion the author reaches is the real role an MLP can play in the search for oil. With one exception, quoted below, this conclusion is reached without reference to the Internal Revenue Code.

> "Many of the limited partnerships and royalty trusts would provide excellent examples of instances where the industry is beginning to depend on the investors for funds, rather than depending on production revenues. However, most of these partnerships and trusts were cast as tax shelters, rather than as commercial ventures. Perhaps the biggest drawback of this shaping by tax considerations is the clouding it may impart to our ability to appreciate the possibility of limited

partnerships and royalty trusts as pure commercial ventures of the kind we are suggesting here".

In 1985 we had little option but to look to a hybrid financing vehicle the primary purpose of which was to raise risk capital in a prudent and cost-effective manner. At that time other companies had formed MLPs and we were afforded the opportunity to assess the cost of capital by looking at the market price of these securities. It proved the least expensive way of raising capital at that time. When we compared the price the public was willing to pay for our reserves in the form of common stock to the price they would pay for direct ownership through an MLP, we discovered a significant difference in favor of the MLP. The value differential can be explained by the substantial undervaluation of oil stocks as compared to the value of the underlying oil production assets. In 1985, the MLP market yielded $8.00 per barrel for our reserves, while the common stock market valued our reserves at $4.00 per barrel. Another reason for the differential is the distribution policies of MLPs. Because MLPs distribute all, or most, of their cash flow, they provide a high yield investment return. The direct relationship of cash flow distribution, investor yield, and unit value of an MLP was demonstrated later in 1986 when the dramatic collapse of oil prices cut the distribution, yield and unit price. From the investor's perspective the elimination of double taxation of earnings is an important consideration, but there are also many non-tax considerations which go to the heart of the investment. These include:

- direct ownership in oil and gas production assets;
- greater potential profit associated with a recovery of oil prices;
- new investment opportunity for upper middle income individuals;
- higher cash yield;
- greater liquidity.

THE IMPACT OF MASTER LIMITED PARTNERSHIPS ON FEDERAL REVENUE

The question of revenue gain for Treasury has been the driving force behind the proposal to tax MLPs as corporations. Reliable economists and revenue estimators from both government and the private sector have short run estimates of proposals like Treasury's that range from losses to very modest gains in federal revenues. Mr. Mentz in his testimony before the House has characterized the short term revenue impact as insignificant, but he places considerable emphasis on the growth of MLPs and the resulting drain on federal revenues in the 1990's.

Two factors are central to the issue of determining future revenue impacts; the growth of MLPs and the extent to which the alternative to raising capital through an MLP is raising capital through debt. If debt is the alternative of choice, Treasury at best is kept whole and, as indicated below, more likely disadvantaged. From a broader financial perspective, action by Congress to limit capital formation through the sale of MLP units would encourage higher debt/total capital ratios in the private sector or reduced capital investment.

In December of 1985 when we formed our MLP, debt was the only viable financial alternative to raising capital, the use of equity would have been extremely expensive. In early 1987, after passage of the TRA of 1986 (which Treasury alleges encouraged the use of MLPs), we again reviewed the market for a similar capital requirement. Due to changes in the financial markets, which clearly overshadowed tax factors, we proceeded with a debt issue to raise this capital.

While Sun does not purport to speak for the oil industry or other capital intensive industries, to the extent Sun is representative of existing or contemplated MLPs, their growth and drain on Treasury appears questionable. It is clear that an important alternative to capital formation could be curtailed should Congress accept Treasury's proposals.

MLPs will also affect tax revenues due to timing and recognition issues.

MLPs may result in an acceleration of tax revenue where units are distributed to shareholders of the sponsor and where units are sold in a secondary offering. A shareholder recognizes taxable income equal to the value of the unit upon its receipt. The distributing corporation also recognizes any gain on the difference between its basis in the distributed unit and its fair market value. In a secondary offering the sale triggers tax on any inherent gain relating to the partnership's underlying assets. Thus, MLPs accelerate receipt of revenue to Treasury in certain circumstances.

The revenue loss associated with the step-up of basis at death would be reduced by the existence of MLPs. Since all income earned by a MLP is taxed currently, there will be less deferred gain on which revenues are lost at the death of shareholders. In contrast, retained corporate earnings may lead to large accrued gains many of which escape taxation through the step-up of basis at the death of shareholders. Any step-up in basis at death with respect to a unit in a MLP would reflect market factors other than retained earnings, resulting in a loss of tax revenues that would occur in corporate form also.

The numerous legal and operational costs inherent in the master limited partnership form of carrying on a business will likely result in confining the use of MLPs to single-purpose high risk activities generating substantial levels of cash flow. The tax exempt sector is unlikely to participate in the MLP market because MLPs generate "unrelated business income" taxable to those organizations. This will discourage MLP formation since tax exempts represent a major segment of the capital market. The corporate form will remain the preferred entity for diversified, multi-national or capital-intensive activities.

In summary, it is critical that the revenue analysis of MLPs takes into account the type of funds, debt or equity, that are replaced by MLPs. Also, the effect of MLPs on the overall corporate debt-equity ratio must be assessed. Equally important, the effect of MLPs on the time pattern of recognition of income by taxpayers must be incorporated in the analysis. While at first thought it might seem that MLPs represent a significant revenue leak from the corporate income tax, we believe that further analysis will show the revenue effect to be much less than it may at first appear.

SUMMARY

Sun considers the availability of its MLP as an important alternative in raising high risk capital. Any tax legislation which would increase the burden on this type of capital formation should only be taken if dictated by sound tax policy considerations. Currently it appears that the major concern of Congress is the possibility of an erosion in corporate tax collections. To date this concern does not appear to be justified. We therefore recommend that no legislative changes be made with respect to the current tax treatment of MLPs.

STATEMENT OF JAMES R. MOFFETT, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, FREEPORT-MCMORAN, INC., TESTIFYING ON BEHALF OF THE FERTILIZER INSTITUTE, NEW ORLEANS, LA

Mr. MOFFETT. Thank you, Mr. Chairman. I am James R. Moffett, Chairman and CEO of Freeport-McMoRan, headquartered in New Orleans, Louisiana. I am here testifying on behalf of The Fertilizer Institute and our company.

I want to first of all say that the idea that a master limited partnership is like a corporation is only understood—he difference between those two—if you manage those two entities. And I can assure you anyone who has managed a master limited partnership as opposed to a corporation would tell you that it is not a similar vehicle.

Second, the venture capital aspects of the legislation that would be considered as recommended by the Treasury, in my opinion, would be devastating to our venture capital market.

We have raised $600 million of equity through the master limited partnership and with that we have, in essence, saved two entities that were both having substantial losses. We bought a company that was mired in debt, was on the verge of Chapter 11 and, by virtue of having this MLP available to us to raise equity, it could not have been bought with a debt security. It could not have been bought with a common stock security because the oil price in June of 1986 when we bid for this company was at its all-time low, that being $10.

Had we not had the ability to have an MLP type of equity financing, which was the only one of the three that has just been described by the Sun people, we would not have been able to do the deal. We just acquired AgriCo. The fertilizer business in 1986 lost $500 million in this country. There have been no taxes collected from any of those corporations, but we were able to use the MLP to go in and rescue that company and frankly turn a significant consolidation into something that has had an immediate impact on the industry; and that is a matter of record.

Since our bid for that company in December of 1986 and the finalization in March, just the consolidation had an industry impact by our being able to have a creative vehicle like the equity financing that was available through the MLP. Now why were those things available to us? They were available to us because we committed to a yield security.

This is the difference between an MLP and a corporation. We as the management have said that, after G&A and operating expenses, we will distribute this income; and therefore, this yield security is going to create a taxable event for our yield holders. If this were a corporation, especially a new corporation—as has been suggested by the Treasury—a new corporation couldn't possibly make a commitment to distribute their cash flow. But in this entity, because we were able to show yields of 13 and 15 percent, because we were willing to—as opposed to putting debt on our company—we were able to let the unit holders get the yield from these entities.

So, these are yield oriented. They are valued on their cash flow yield. If you don't yield the cash flow, you are going to lose your value. We have to have more venture capital.

The commodities in this country have been decimated. The mining business, the natural resources business in general are going to have to be completely rebuilt. The commodity down cycle, the strong dollar have destroyed the domestic natural resources business. We have to have venture capital to rebuild it. It won't be done with stocks. It won't be done with bonds.

We have to have these creative vehicles. I think the amount of companies—if we are going to talk about legislation to try to stimulate the economy—we must not lose the integrity of the United States investors. If we keep changing the rules, as this would be, we have over $3 billion of our assets into these MLPs. We have spent millions of dollars to put them there. We have investors who have relied on the fact that this was a legal entity in which they could invest.

If we keep changing the rules, especially in the light of the passive loss—passive income—at-risk rules that were changed in the 1986 Tax bill—and I am not saying whether that was good or bad—I am saying it has happened; and I say that our venture capital formation will be strongly eroded if we do not convince people in this country that we are not going to lose the integrity of our investment where, if people invest and put their money into a project, that they can count on the way it is going to be taxed. So, I believe that we need to do it for that reason.

In my opinion, if you change the MLP into a corporate form, you stop the ability of the small investor—the retail investor, the $2,000 to $5,000 investor—who can invest in these commodities through this MLP. It is the only thing they have left. No individual is going to invest directly in natural resources. They can't afford the unlimited liability. So, we have to be able to have those sorts of participation.

It is not fair to exclude our small retail investor, which is the way this capital is principally raised, from the ability to invest directly in the future of the natural resources in America. I don't think that that is the intention of the Congress. I don't think it is the intention of the tax law to do that. And that is what we basically will do.

There will be nothing but stocks and bonds left for people to be able to participate in. A small investor has to have yield; an MLP has a yield security. It is based on that, and people will have to distribute income from these vehicles.

It is much different from a corporation, as I say. All you must do is manage one of these to understand it. I think that the suggestion that there is a major threat to the corporate tax base in this country is absolutely ridiculous. New companies that may form are going to have to look very hard. If they go into an MLP as a new company, it is going to be very difficult for them to commit that they will distribute all usable cash flow. It is against the principle of forming a new company. And with the repeal of the General Utilities Doctrine, assets that are already in corporate form are not going to be done. So, there is no smoking gun here.

There is no significant erosion of our revenues because of the existing laws. And I appeal to you to not keep changing the rules. We have a tough enough time rebuilding the natural resources business. The risks are there; we need the small investors. Let's not exclude him. Thank you very much.

Senator BAUCUS. Thank you, Mr. Moffett. Next, we will hear from Mr. Sandler.

[The prepared statement of Mr. Moffett follows:]

STATEMENT
OF
JAMES R. MOFFETT
FREEPORT-MCMORAN INC.
TO THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

JULY 21, 1987

Mr. Chairman and Members of the Subcommittee:

I am James R. Moffett, Chairman of the Board and Chief Executive Officer of Freeport-McMoRan Inc. (FMI). I appreciate this opportunity to present my views on the subject of master limited partnerships (MLPs) and to provide the Subcommittee with information regarding FMI's own experience with master limited partnerships.

FMI is a leading U.S. fertilizer producer. It is the largest producer of phosphate-based fertilizer in the United States with a vertically integrated operation that includes the mining of phosphate rock and the production of phosphoric acid and phosphatic fertilizers. FMI also is a leading manufacturer and distributor of nitrogen-based fertilizer in the United States and accounts for about 15 percent of U.S. nitrogen-based fertilizer capacity. FMI is a diversified natural resources company which is involved in the exploration, development, mining, production, and/or processing of a variety of minerals including sulphur, oil and gas, gold, copper, silver, uranium, phosphates, and geothermal energy.

At the present time, FMI conducts its sulphur and fertilizer chemicals mining and processing businesses, its geothermal energy business, and its uranium recovery technology business through a master limited partnership, Freeport-McMoRan Resource Partners, Limited Partnership, in which it owns approximately 72 percent of the partnership interests. In addition, FMI conducts its oil and gas business through another MLP, Freeport-McMoRan Energy Partners Limited, in which it owns approximately 75 percent of the partnership interests. These partnerships were formed by FMI in June 1986 and April 1985, respectively. In each case, FMI and its affiliated companies contributed the pertinent assets and businesses to the MLP and then sold a portion of the interests in the partnership to the public in a taxable transaction.

For FMI, MLPs mean --

- **An essential source of capital.**
- **A substantial enhancement of the value of FMI stock.**
- **Significant growth of the company and expansion of its asset base.**
- **The source of substantial, additional dividends for FMI's shareholders.**
- **Larger, not smaller, federal income taxes.**

Utilization of the partnership form of conducting business has been a traditional and long-standing practice in the natural resources industry. Partnerships provide a means of obtaining the funds needed for the conduct of the businesses and spreading the risks that are inherent in natural resource exploration, development, and production. FMI's adoption of the MLP form of conducting business for its fertilizer chemicals, sulphur, geothermal energy, uranium recovery technology and oil and gas businesses was simply the extension in the context of today's capital markets of the traditional partnership form of doing business in the natural resources industry.

FMI's MLPs, however, have served not only the traditional purpose for which partnerships have been used in the natural resources industry -- raising the capital that is needed to carry on and expand the business -- but they also have provided the means for a substantial enhancement of the value of FMI's shareholders' investment in the company. **Prior to formation of the MLPs the market was undervaluing FMI's assets and businesses and hence its stock. By forming and marketing interests in the MLPs, FMI countered this undervaluation. Since the end of 1984, the aggregate market value of FMI's common stock has increased by 73 percent.**

Here's how FMI's MLPs have worked to substantially enhance the value of its stock for the benefit of its shareholders. Experience has shown that the marketplace often fails to adequately focus on the underlying value of a company's businesses and assets and, thus, it undervalues the company's stock. This is what was happening in FMI's case. The initial sale of approximately 15-20 percent of FMI's businesses to the public through interests in MLPs has permitted the capital markets to separately focus on and evaluate the underlying assets of, and the separate businesses carried on by, the MLPs. The marketplace's valuation of the MLP interests which are held and traded by the public provides the basis for valuing the entire business conducted by each MLP. If those businesses were still conducted in wholly owned subsidiaries of FMI as had been done in the past, the opportunity for separate market valuation wouldn't exist. As a result, those businesses and assets, as well as FMI's stock, still would be undervalued. FMI's conduct of its businesses through MLPs, however, has somewhat mitigated this market myopia.

These significant economic, non-tax benefits to FMI and its shareholders have been obtained without any tax cost to the federal Treasury; indeed, federal revenues have been increased because of FMI's MLPs. One of the most frequent charges that critics of MLPs make is that they will result in the "disincorporation" of America and the loss of tremendous amounts of federal revenues in the process. Both of these charges simply do not stand up under scrutiny. First, after the 1986 Tax Act, the tax cost of completely disincorporating existing businesses and transforming them into MLPs in most cases is prohibitive. Second, as FMI's own experience demonstrates, to the extent MLPs are used as a means of raising capital, as partnerships traditionally have been in the natural resources industry, there is no significant revenue loss associated with the MLPs and there may well even be revenue gains.

In 1987 FMI expects to pay 50 percent more federal income tax as the result of conducting its natural resources businesses through MLPs than it would have paid if it had raised the same amount of capital by the traditional means of debt financing.

It must be remembered that FMI remains fully taxable with respect to the approximately 75 percent interest it continues to own in each of its MLPs. It is true that FMI is not taxable on the approximately 25 percent of the income from the MLPs which is earned by the public holders of the partnership interests. That result, however, would not be significantly different if those persons had loaned the money to FMI for the conduct of its businesses.

The whole concern directed toward MLPs about revenue loss and disincorporation fails to recognize a fundamental characteristic of the conduct of business in America today. **If the capital funds needed by a corporation to carry on and expand its business are not obtained through the sale of partnership interests in an MLP, those funds will be** obtained in most cases by debt financing. The interest deduction in the case of debt financing means that no corporate income tax is imposed with respect to the great bulk of the income earned by funds provided through the debt financing; it is only the incremental earnings on the capital above the cost of capital that bear any corporate income tax.

The single level of taxation of partnership income and the interest deduction allowed with respect to borrowed funds means that the return on the capital in each case -- partnership capital in one, debt-financed capital in the other -- essentially bears only one level of federal income taxation. There is little corporate tax on that income. The only significant level of taxation is at the level of the recipient of the partnership income or the interest.

Moreover, as a result of placing its natural resources businesses in MLPs, FMI has grown and expanded its natural resources base of assets and is paying more federal income tax today than it would have been had it used debt financing to obtain the needed capital funds. Since the end of 1984, the book value of FMI's assets, after reflecting the SEC-mandated write-down of oil and gas assets, has increased by over 39 percent. Excluding that write-down, FMI's assets have increased by 54 percent. Thus, although FMI has placed most of its business in MLPs, the MLPs have not resulted in the disincorporation of FMI. Rather, MLPs have allowed FMI to expand and grow, to increase its natural resources reserves, and to become a stronger company.

It is unlikely that FMI could have obtained through debt financing the amount of capital funds it has been able to obtain through the sale of partnership interests in its MLPs. It also would not have been practicable for FMI to obtain these capital funds through the sale of FMI stock. As previously indicated, the marketplace was already undervaluing FMI's stock. It had not focused on the underlying value of FMI's assets and businesses. To attempt to raise capital funds in that context by the issuance of additional stock would only have worsened the problem by further depressing FMI's stock price and thereby harming, rather than benefitting, FMI's shareholders.

MLPs provide another substantial benefit to FMI and its shareholders. FMI has been able to distribute to its shareholders in excess of $100 million of dividends in the form of partnership interests in the MLPs. Not only has this been an obvious benefit to FMI's shareholders but, in addition, it has benefitted the federal Treasury because FMI's shareholders have received $100 million of additional taxable dividend income. The distribution of interests in its businesses to FMI's shareholders would not have been possible if those businesses were conducted in corporate form because it would have caused the deconsolidation of those companies for tax purposes.

Finally, some people have argued that MLPs are different for tax purposes than other partnerships either because they have a large number of partners or because the partnership interests are readily saleable. Neither of those arguments stands up upon analysis and scrutiny. No rational basis exists for taxing MLPs differently than other partnerships; if MLPs were taxed as corporations, all partnerships would have to be taxed as corporations.

The fact that a limited partnership has many partners does not change the relationship among the partners to anything other than a partnership relationship. No difference exists between the nature of the relationship a limited partner has in and to a partnership in which there are four limited partners and one in which there are 4,000 limited partners. In neither case is a relationship of the limited partner to the partnership and the other partners the relationship of a shareholder to a corporation. Moreover, and very importantly, the number of limited partners does not change the fact that there are one or more general partners who have unlimited liability for the debts and acts of the partnership; that fundamental characteristic is not present in a corporation.

Similarly, the fact that a partner can easily sell his interest in a partnership does not alter or transform that person's relationship to the partnership to something other than that of a partner and it does not change the partnership into something other than a partnership.

No rational line can be drawn between large and small partnerships or between partnerships, the interests in which are readily saleable, and those in which they are not. There is no way to outlaw big partnerships or readily tradeable partnerships for tax purposes without doing away with all partnerships. There is simply no meaningful distinction between the various types of partnerships for federal income tax purposes.

Partnerships, large or small, tradeable or not, represent a long-standing, traditional means of doing business in America, particularly in the natural resources industry. They provide a means by which businesses can raise the capital needed to carry on and expand their activities in the form of equity rather than debt. Whether the needed capital is obtained through debt financing or the sale of interests in MLPs, essentially only one level of taxation is imposed. Accordingly, the choice of one form of financing over the other does not significantly affect the federal tax revenues. Attacking MLPs on the basis that they will create a revenue loss is like tilting at windmills. It simply isn't the real world.

I would like to make one last point in closing. The U.S. suffers from a serious trade deficit and we as Americans are concerned about our ability to compete in the world marketplace. To be competitive, American business must devote its full attention to running and improving its businesses and creating new profit opportunities. To develop necessary operating strategies and plans for being competitive, American business requires certainty regarding its fiscal obligations. There has been major tax legislation in four out of the last six years. In my judgment, it's time for the Congress to stop this process and let American business get on with the job of becoming more competitive to regain its rightful place in the world marketplace rather than having to focus its attention on taxation and what Congress might be attempting to do to change the way we do business today. No other country subjects its industries to such uncertainty and distractions. In fact, other nations use their tax law to subsidize their industries so as to improve their competitive position in the marketplace.

STATEMENT OF LEWIS H. SANDLER, GENERAL PARTNER AND GENERAL COUNSEL, SOUTHWEST REALTY, LTD., TESTIFYING ON BEHALF OF THE NATIONAL APARTMENT ASSOCIATION AND THE COALITION OF PUBLICLY TRADED PARTNERSHIPS, DALLAS, TX

Mr. SANDLER. Mr. Chairman, my name is Lewis Sandler. I am appearing before you today on behalf of the Coalition of Publicly Traded Partnerships, the National Apartment Association and Southwest Realty, a publicly traded limited partnership or MLP, of which I am personally one of the general partners.

I appeared before this same august body in 1983 shortly after we began trading, when a hue and cry arose that we were going to start—along with several other MLPs—a disincorporation of America. That was back in 1983, and I feel a little bit like the baby that everybody is trying to throw out with the bath water.

There are two popular misconceptions about MLPs that I would like to address this morning. The first is that MLPs are formed primarily for the purpose of avoiding corporate taxation. It is not true. And the second is that an MLP walks and talks like a duck and, therefore, it should be taxed as a corporation. Most MLPs, in fact, have been formed for reasons that are totally unrelated to corporate taxation.

Southwest Realty, for example, was created in 1982 as a roll-up of existing partnerships. There were three major considerations for our roll-up, none of them were tax related.

The first and foremost consideration was the liquidity that we could offer to our investors. In addition, we were able to gain access to a larger group of middle class investors.

The second most important factor behind our roll-up was the ability to raise additional capital—additional capital that our predecessor partnerships, in fact, were unable to raise. Shortly after we became effective, we had an additional equity offering, raised additional equity capital, and used it to retire debt. Angel Care, a nursing home, is another example an MLP that was created for similar reasons.

A third important factor—at least to our MLP—was our ability to retain management control—to control our own destiny. Traditionally, a limited partnership format includes no readily available mechanism for a change in its management.

We built in certain so-called "democracy provisions" but at far less expense to the equity investors than a typical corporation or real estate investment trust—both of which formats we studied closely and rejected as being unworkable for us.

In passing, I would also like to note that we were born with the knowledge and blessings of the Treasury Department. We obtained a private ruling from the Treasury Department, without which we would not have gone forward with our MLP. It is unlikely that others would have followed us without that ruling.

Other reasons for forming an MLP include the retirement of debt. At least one MLP, Commonwealth Savings, was a troubled savings and loan association in Houston and used the proceeds from a public offering to retire debt and helped place itself on a firm economic foundation.

Other MLPs have been formed in order to increase the value of corporate stock by highlighting undervalued assets. International Paper Company rolled out its timber holdings into an MLP in order to recognize their value. Still others have formed MLPs in order to increase the difficulty of a hostile takeover. None of the foregoing reasons are tax-motivated.

The other item that I would like to address briefly is the often heard statement that if it walks and talks like a duck, it should be taxed as a corporation. The fact that MLPs are tradeable and have a relatively large number of investors are indeed two factors that are common to both MLPs and publicly traded corporations. Forgetting for the moment that the vast majority of corporations enjoy neither of these characteristics, I would like to point out some of the substantive differences between MLPs and corporations.

One of the reasons is perpetual life. As you know, corporations are perpetual in nature, while publicly traded partnerships—like all partnerships—are for a fixed term of years. Further, unlike corporations, all partnerships, including MLPs, may be terminated unintentionally by any one of several occurrences. The second substantive difference is liability, which was mentioned earlier.

As you know, generally corporations offer their principals and investors complete freedom of liability. Partnerships differ in two substantive ways. The first is that you must have a general partner that is financially responsible and to whom creditors can turn if the entity itself cannot pay its debts. And the second is that a partnership's investors may be liable for the return of distributions plus interest in order to satisfy creditors whose claims arose prior to those distributions.

These are significant disincentives to principals and investors alike.

A third substantive difference is control. Generally, corporate charters provide for the election of directors (who control management) by shareholder/investors. Partnership certificates generally do not provide for any change in management, except where the general partner is guilty of gross negligence of malfeasance.

Another important substantive difference is the taxation on undistributed income. Unlike corporate shareholders, partners in MLPs are taxed on their share of partnership income whether or not cash is distributed to them. This potential for phantom income is a disincentive to investors. It also puts pressure on an MLP to maintain high cash distributions rather than to retain and reinvest earnings.

I might add here that, contrary to what Secretary Mentz has said, I don't believe that DeLorean or any other corporation or potential startup business like DeLorean would use an MLP; it would be suicidal, especially because of potential liability and because there is a need in a corporation like that—in a business like that—to retain earnings.

Those are some of the substantive differences between corporations and MLPs, with one exception: none of them are tax related, although there are similarities between corporations and MLPs, or for that matter, between corporations and almost any form of investment vehicle, there are important differences, too.

The fact is that MLPs walk and talk like partnerships and should continue to be taxed as such for tax purposes.

In closing, I would like to leave you with a statement made in February 1984 before the House Ways and Means Committee at hearings on tax shelters, accounting abuses, and corporate and securities reforms. The statement was made on behalf of Mercedes-Benz by its then-outside counsel, J. Roger Mentz, who was concerned about a proposal to limit tax benefits on passenger automobiles used for business purposes to the first $15,000 of cost. Mr. Mentz stated, and I quote:

> To the extent that there is a personal benefit problem with automobiles, it exists for all automobiles, not just those priced over $15,000. If you are absolutely bound and determined to achieve a legislative solution on automobiles, do it in a way that is nondiscriminatory.

Continuing with Mr. Mentz's analogy, if you are bound and determined to make legislative changes in taxation of pass through entities, do it in a way that is nondiscriminatory. Treat all master limited partnerships alike, and treat all master limited partnerships in the same manner as you treat all partnerships. Thank you.

Senator BAUCUS. Thank you, Mr. Sandler. Mr. Cohen?

[The prepared statement of Mr. Sandler follows:]

TESTIMONY OF LEWIS H. SANDLER
GENERAL PARTNER, SOUTHWEST REALTY, LTD.
ON BEHALF OF
THE COALITION OF PUBLICLY TRADED PARTNERSHIPS

Thank you for inviting me to appear before this Subcommittee on behalf of the Coalition of Publicly Traded Partnerships. The Coalition is a trade association representing publicly traded limited partnerships and those who work with them, including attorneys, accountants, and investment bankers. In addition to serving on the Board of Directors of the Coalition, I am also a member of the National Apartment Association which concurs in my testimony today.

I am a General Partner of Southwest Realty which is a publicly traded or "master" limited partnership ("MLP") engaged in the ownership and operation of income-producing real estate, primarily multifamily housing units in the southwest. Southwest Realty commenced operations and trading of depositary receipts representing the economic attributes of its limited partnership interests in February of 1983. Southwest Realty was created through a "roll-up" of 14 existing limited partnerships, each owning its own cash flowing, income producing property. The primary source of equity capital for Southwest Realty, as for all new construction of multi-family housing in this country, has traditionally been through the partnership format.

There were three major considerations behind our roll-up. None of them were tax-related. The first and foremost consideration was liquidity. Prior to February 1983, we were not able to offer our limited partner investors an opportunity to sell or hypothecate their limited partnership interests. Nor were these investors able to effectively utilize their illiquid partnership investments in their estate planning. Prior to the advent of MLPs, traditional investment partnerships did not enjoy liquidity. That has changed today with the listing for trading of some (currently still fewer than 100) limited partnerships and the creation of other investment vehicles designed to acquire limited partnership interests in existing (otherwise illiquid) limited partnerships.

Our liquidity, by the way, was born with the knowledge and blessings of the Treasury Department. We applied for and received a private ruling from the Treasury Department that our PTP would be treated for federal income tax purposes as a partnership. The ruling was issued on the basis of certain factors, including the anticipated listing of our depositary receipts for trading on a national exchange. Without such a ruling we, and others who followed in our footsteps, would not have ventured onto Wall Street.

Today we are still a limited partnership. We are still engaged in the ownership and operation of substantially the same income producing real estate that we owned and operated in 1982 when we obtained the ruling. We are trading regularly in an orderly market. We continue to file tax returns and issue K-1's to our investors. Nothing has changed. Some, however, have been advocating that we be treated for tax purposes as a corporation. I submit that such treatment is inequitable and unnecessary.

We have deprived the government of no revenue. We do not market our depositary receipts on the basis of tax advantages. In fact, to the best of our knowledge, the investing public has never paid a penny for the tax aspects of our MLP; rather, we believe that they have purchased the depositary receipts because of the yield or underlying value of the assets. This is probably true of most of the MLPs in the marketplace, although there are a few that are basically service oriented and appear to trade on the basis of their earnings, actual or potential.

The second most important factor behind our roll-up was the ability of Southwest Realty to raise capital - additional capital that its predecessor partnerships were unable to raise. In fact, subsequent to the completion of the roll-up, we raised a substantial amount of additional capital in the form of equity through a public offering of our depositary receipts. The proceeds from this offering were used primarily to retire existing debt.

Although generally an MLP has the ability to issue additional equity or debt, we and many of the other MLPs have found that in industries such as real estate, additional capital in the form of equity, is more readily available, and the cost more economic, than additional debt. In the Southwest, where our multifamily housing projects are located, market conditions today do not lend themselves readily to new debt issues. In fact, the newspapers are full of articles regarding the inability of existing income producing real estate to meet current debt obligations. For some, the ability to raise additional capital in the form of equity may be the means for survival.

A third factor important to and inherent in an MLP is management's control of its own destiny. Frankly, when we were considering our roll-up, we considered and rejected the corporate format because we had no desire to go to the trouble and expense of changing our business format only to have the company taken over by corporate raiders.

Traditionally, a limited partnership structure includes no readily available mechanism for a change in management. Prospective purchasers of limited partnership interests are generally aware that they are buying a management team and that in the absence of malfeasance it is difficult at best, to replace that team. A review of most of the MLPs that have come to market in the last four years has led me to believe that the control issue is a dominant factor in the sponsor's determination to adopt a partnership format. That is not to say that minimum so-called "democracy" requirements are not observed. I believe that they are, but at far less expense to the equity investors.

Southwest Realty is only one MLP, but my story is typical of the other MLPs in the Coalition, and of the roughly 99 MLPs that are currently being traded. With the exception of a few corporations that liquidated in the rush to beat the repeal of General Utilities--and I want to emphasize that these are a very small part of the overall total--MLPs have been formed for the primary purpose of raising capital, not for tax reasons. Let me give you a few other examples from within the Coalition:

> Commonwealth Mortgage of America, L.P. was a roll-out of the mortgage banking business of Commonwealth Savings, a troubled savings and loan in Houston. The purpose of the roll-out was 1) to provide Commonwealth Savings with much needed cash from the sale proceeds and a portion of future distributions, which in turn was used to pay off debt and 2) to increase the market value of Commonwealth's shares by segregating and highlighting this portion of Commonwealth's business.
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> International Paper Company rolled out its timber holdings into IP Timberlands in order to 1) increase the market value of the company's stock by segregating its undervalued timber assets so that their value could be recognized; 2) raise additional capital for new acquisitions to increase its timberland base without incurring further debt or diluting existing corporate equity; 3) obtain access to middle income investors by offering them a liquid and easily affordable investment. International Paper retained most of the units in IP Timberlands, and 95% of the distributable income in 1985, and 83% in 1986 went to International Paper and was subject to corporate taxation.
>
> Angell Care, Inc., a nursing home company which had been accustomed to raising capital through traditional non-traded partnerships and other pass-through entities in the past, decided in 1986 that it would be more efficient to obtain capital through one large MLP rather than the two to three smaller partnerships that would be need to meet that year's needs. In addition, the MLP would allow Angell Care access to a new set of investors--the smaller, middle income investors, who had not been reachable in the companies' previous offerings. Angell Care M.L.P., an "acquisition" type MLP was formed, and the proceeds were used to purchase additional nursing homes.

In short, the formation of MLPs is not dictated by a desire to avoid corporate taxation, and as the example of International Paper shows, that is really not the effect. Rather, MLPs are formed for any or all of the following reasons:

1) to raise capital for various purposes without incurring debt or diluting equity,

2) to retire debt,

3) to increase the value of corporate stock by highlighting undervalued assets,

4) to provide liquidity and to increase the size of the available investment pool by raising capital from the small investor,

5) to increase efficiency by consolidating several smaller partnerships, and

6) to increase the difficulty of a hostile takeover.

Having discussed why MLPs are formed, and I hope having laid to rest the "tax avoidance" notion, I would like to address two other common misconceptions about MLPs: that they will cause a "revenue hemorrhage" and that they look too much like corporations to be taxed as partnerships.

To begin with, let me state emphatically my belief that MLPs are not currently and will not in the future be significant revenue losers. Assistant Treasury Secretary J. Roger Mentz, in testimony before the Ways and Means Committee's Subcommittee on Select Revenue Measures three weeks ago, presented a table showing a revenue gain from taxing new MLPs as corporations of $215 million over the budget reconciliation period of fiscal years 1988 - 1990. He also claimed that this figure would grow dramatically in later years if MLPs were allowed to continue untaxed.

While $215 million over three years is an insignificant figure from a budget standpoint, even $215 million is an overstated and misleading figure. Secretary Mentz admitted in his testimony that the revenue raised by treating MLP income as portfolio rather than passive income is subsumed in the estimate for taxing MLPs as corporations. If the $78 million estimated for applying the portfolio income rule to new MLPs is subtracted, the three-year figure drops to $137 million.

Furthermore, in both the short term and the long run, both roll-ups and roll-outs often result in a one-time revenue gain to the Treasury due to partial recapture of the investment tax credit, possible recapture of depreciation or depletion, and loss of percentage depletion.

The formation of an MLP through the roll-up method could not possibly lose revenue in the long run, as the rolled up partnerships were not taxed at the entity level before becoming part of the MLP. If these MLPs are taxed as corporations, they are likely to convert back to privately held partnerships, resulting in no increase in federal revenues.

The liquidity of MLP interests results in relatively rapid recapture and taxation of appreciated value as the interests change hands. Non-traded partnership interests are illiquid, thus delaying the realization of revenues to the government, while the disposition of corporate stock results in no recapture income. Thus, roll-up MLPs in particular should actually increase federal revenue.

Turning to roll-outs, secondary public offerings of MLP interests by corporations forming MLPs through a roll-out result in capital gains and recapture tax to the corporations, which are in effect selling assets or an undivided interest therein. If corporations distribute their MLP interests to shareholders, the shareholders are taxed as if they had received a dividend.

As we have seen, corporations form roll-out MLPs as a means of raising additional capital without incurring debt or diluting shareholder equity. MLPs are also used to retire existing debt and, in some cases, are a substitute for a leveraged buyout. If MLPs are unavailable as a capital formation tool, corporations will instead use debt financing. Rather than enhancing federal revenue, this will result in revenue loss through interest deductions which, because many corporate investors are tax-exempt institutions, often will not be matched by taxable interest income, resulting not only in single but zero taxation. Raising capital through an MLP, on the other hand, ensures that at least one level of tax will be paid.

As the International Paper example shows, substantial amounts of income from roll-out MLPs are subject to double taxation, as the corporate general partner and any corporate limited partners will be taxed at the corporate level on their share of partnership income. In most roll-outs, the corporation retains a substantial portion of the partnership units--as much as 96% in some cases.

Even after tax reform, a significant portion of corporate earnings will escape double taxation, due to the extensive use of debt, with corresponding interest deductions; the high proportion of tax-exempt institutions among corporate investors; and retention of earnings. MLPs, on the other hand, use far less debt and distribute most of their earnings to investors, the vast majority of whom are taxpaying individuals, on a current basis.

In fact, of the four means of raising capital--the issue of new corporate stock, debt, use of retained earnings, and MLPs--only the first is double taxed. Only 8% of corporate investment between 1950 and 1983 was financed through stock issues. The other methods are subject to at most one level of taxation, and in the case of debt held by tax-exempt investors, to no taxation at all.

I understand that Treasury is concerned that new businesses will start out as MLPs rather than as corporations. However, it should not be assumed that businesses which start out as MLPs rather than being rolled up or rolled out from other entities would have incorporated had the MLP option not been available. Most of these businesses would have chosen to do business as non-publicly traded partnerships, or would have chosen another pass-through entity. If they chose the corporate form, they would probably be highly leveraged. There is thus little revenue to be gained from preventing companies from starting out as MLPs.

In short, the existence of publicly traded limited partnerships does not pose a threat to the federal revenue base. Taxing MLPs as corporations will do little to preserve or increase federal tax revenues, and may actually result in a revenue loss.

I would now like to address the "corporate characteristics" issue, particularly the idea that size and tradeability are appropriate criteria for determining tax treatment. It appears that much of the interest in changing the tax treatment of publicly traded limited partnerships has been generated by a belief that these entities so closely resemble corporations that equity compels it. This resemblance is superficial, however, based almost entirely on size and public trading. These elements are not determinative criteria under current law, and I feel that they should not be under any new system of classification that Congress or Treasury might adopt.

Under the current classification regulations, known as the Kintner regulations, a partnership is defined as any unincorporated organization which carries on a trade, business, financial operation, or venture. The organization will be treated as a taxable association rather than a partnership for tax purposes if it is composed of associates who have an objective to carry on a business or financial enterprise and divide the gains and also possesses at least three of the four "corporate" characteristics: 1) continuity of life; 2) centralization of management, 3) limited liability, and 4) free transferability of interests.

Publicly traded limited partnerships have been classified as partnerships by the IRS because they do not possess two of the four characteristics. While it is generally conceded that publicly traded limited partnerships possess centralized management, and of course their interests are freely traded, they do not possess continuity of life and limited liability. Those who would focus on tradeability as the determining criterion, therefore, would be greatly magnifying the importance of a characteristic which for the past twenty-seven years has--quite correctly--been only one of four equally weighted criteria.

One of the reasons that you are here today is to decide whether the Kintner regulations need reworking. If that is done, I want to urge that you avoid the temptation to make size and tradeability the primary criteria for distinguishing partnerships from corporations.

In the first place, public trading has never been in fact a determinative or even significant characteristic of corporate status. The stock of some 98% of all corporations is not publicly traded. Furthermore, the use of public trading as a determinative factor poses real definitional problems. Markets are now developing for syndicated partnership interests. Some of these markets are exchanges; others are not. Some are regulated; others are not. Tradeability is an artificial and inappropriate criterion for deciding whether a partnership ought to be treated as a corporation for tax purposes. It is an external characteristic that has little to do with the intrinsic nature of an organization and its business activities.

In connection with the issue of tradeability, we refer you to a statement made to the Senate Finance Committee on October 24, 1983 by the then Deputy Assistant Secretary for Tax Policy, Department of the Treasury. Speaking on behalf of the Treasury Department against a proposal to tax publicly traded limited partnerships as corporations, Mr. Pearlman stated "...We have serious doubt that after such an analysis, one would conclude that the degree of marketability of an organization's equity interest should determine the manner in which the organization is taxed." We concur with Treasury's position as so stated by Mr. Pearlman.

For similar reasons, the use of size as a determinant is equally inappropriate. Many syndicated, non-traded partnerships are as large as or larger than many publicly traded partnerships. Many corporations are far smaller--the majority have less than a million dollars in net worth. The number of participants in an organization or the size of its business assets is simply not a valid or relevant criterion for determining federal tax classification.

These criteria are inappropriate not only because they are inaccurate, but because they create a conflict with state partnership laws (generally the Uniform Limited Partnership Act or Revised Uniform Limited Partnership Act), which treat publicly traded limited partnerships as partnerships rather than corporations, and because they ignore several differences between publicly traded partnerships and corporations that are far more significant than size and tradeability. These differences, which tend to work to the disadvantage of partnerships, are important both to an individual's investment decision and the taxpayer's decision as to which form of business to adopt. These differences also belie the argument that MLPs "look like a duck, walk like a duck and therefore should be taxed like a corporation." They include:

Liability: As noted above, MLPs, like other partnerships, do not offer investors completely unlimited liability. The assets of at least one general partner in an MLP must be substantial and must be reachable by creditors. In addition, the limited partners may also be reached by the partnership's creditors in certain case. They may be liable for the return of any distributions of capital, plus interest, in order to satisfy creditors whose claims arose prior to the distributions. This is a signficant disincentive to investors.

Perpetuity: Also as noted above, corporations are perpetual in nature, while publicly traded partnerships, like all partnerships, are for a fixed term of years and may be terminated unintentionally by any one of several occurrences.

Taxation on undistributed income: Unlike corporate shareholders, partners in a publicly traded partnership are taxed on their share of partnership income whether or not cash is distributed to them. This is a disincentive to investors and, because it puts pressure on the company to maintain high cash distributions rather than to retain and reinvest earnings, a major disincentive for business owners.

Limits on institutional investors: Institutional investors such as tax-exempt pension funds, universities, and private foundations are a major source of capital for corporations. Various state and federal laws, however, restrict the ability of these institutions to invest in publicly traded limited partnerships.

State law: As noted above, publicly traded limited partnerships operate under state partnership, rather than corporate law. The fact that state partnership law is less comprehensive and settled than corporate law is another disincentive to business owners.

The foregoing are some of the substantive differences between corporations and MLPs. With one exception, they are not tax-related. Although there are similarities between corporations and MLPs, or for that matter, almost any form of investment vehicle, there are important differences, too. The fact is that MLPs "walk and talk" like a partnership and should continue to be treated as such for tax purposes.

An entity level tax has been imposed on corporations at least partially as payment for the benefits they receive from incorporation. And ever since the income tax was first imposed, businesses have been able to make the tradeoff. They have been able to choose whether to enjoy the benefits of incorporation and pay a corporate tax in return or to forego these benefits along with the tax. There is no reason why either size or public trading should be enough to deny businesses this choice.

In short, when you examine the question of classification and pass-through entities, I urge that you resist the temptation to impose a standard that would base entity level taxation on factors such as size or public trading which have little to do with the form in which businesses have chosen to operate. I understand the appeal of these criteria; they appear on the surface to be simple and easy to apply. But one thing that I am sure you have learned in the process of tax reform is that simplicity can often work against logic and equity.

The fact that an MLP is large and publicly traded does not mean that it enjoys the benefits of incorporation and should pay for them through a corporate tax. In fact, MLPs enjoy very few of the advantages that corporations do. That is why they are still less than one percent of the capital market. To impose a corporate tax on them would not serve the cause of equity. It would, in fact, do just the opposite. As a businessman and the general partner of a MLP, I ask that you continue to allow us to chose for ourselves which benefits and burdens are the best ones for our companies to assume.

In closing I would like to leave you with a statement made in February 1984 before the House Ways and Means Committee at Hearings on Tax Shelters, Accounting Abuses and Corporate and Securities Reforms. The statement was made on behalf of Mercedes Benz by its then outside counsel, J. Roger Mentz, who was concerned about a proposal to limit tax benefits on passenger automobiles used for business purposes to the first $15,000 of cost. Mr. Mentz stated, "To the extent that there is a personal benefit problem with automobiles, it exists for all business automobiles, not just those priced over $15,000. ...if you are absolutely bound and determined to achieve a legislative solution on automobiles, do it in a way that is nondiscriminatory."

Continuing with Mr. Mentz's analogy, if you are bound and determined to make legislative changes in the taxation of pass-through entities, do it in a way that is nondiscriminatory. Treat all master limited partnerships alike, and treat all master limited partnerships in the same manner as you treat all partnerships.

STATEMENT OF LAWRENCE A. COHEN, FIRST VICE PRESIDENT, VMS REALTY PARTNERS, AND CHAIRMAN, LEGISLATIVE AND REGULATORY AFFAIRS COMMITTEE, INVESTMENT PARTNERSHIP ASSOCIATION (IPA), TESTIFYING ON BEHALF OF IPA, NEW YORK, NY, ACCOMPANIED BY CHRISTOPHER L. DAVIS, PRESIDENT, INVESTMENT PARTNERSHIP ASSOCIATION

Mr. Cohen. Thank you, Mr. Chairman. I am Lawrence A. Cohen, First Vice President of VMS Realty Partners and Chairman of the Investment Partnership Association's Legislative and Regulatory Affairs Committee. I appear here today on behalf of the Investment Partnership Association, and I am accompanied by Christopher L. Davis, President of the IPA.

VMS is a full-service real estate investment firm engaged in the acquisition, development, finance, and management of real estate throughout the United States. The IPA is the national organization of investors and sponsors involved in all aspects of partnerships. The association's technical task forces made up of people with extensive experience in the partnership area are eager to be a resource to the subcommittee and its staff in developing solutions to any technical and compliance problems that may be found.

The work of our consultants, including recently developed materials developed by Counts and Greenspan, will be available to you. Master limited partnerships are an important subject, with your interest and oversight, having become much more common since their introduction in the late 1980s.

MLPs are a convenience and efficient entity for holding income-producing assets regularly valued in the marketplace. Unlike the ordinary limited partnership, MLPs permit people to buy or sell partnership interests on an established securities exchange. This liquidity is important in attracting equity capital, seeking currently distributed income, taxable only once at the partner level. We believe it is reasonable to suggest that MLP income—although taxed only once at the partner level—on a net basis may be taxed at about the same level as income earned through a conventional corporation.

Although corporate income is subsequently distributed as a dividend to shareholders, under the two-tier system the taxes on income earned at the corporate level and then taxed again that same income at the shareholder level, when dividends are received, you will see that there are a variety of ways that this tax burden can be minimized.

Corporations have increasingly been leveraging their investments through debt financing. This practice may make the long-term financial position more precarious. Such borrowings reduce corporate tax payments through use of the interest deduction. Furthermore, tax exempt entities such as pension funds, endowments, or qualified foreign investors may receive a substantial share of corporate interest payments free of tax.

This suggests to us that MLPs may in fact generate taxable income to the same extent our two-tier tax system does now. As you review the tax treatment of MLPs and partnerships generally, we urge you to carefully review existing law and the Subchapter C study to be submitted to Congress before the end of 1987, before taking any final action.

We also hope you will carefully review the case studies contained in our written testimony, which summarizes the very real activities you may affect by any changes you may choose to recommend to the full Finance Committee.

Partnerships, as you know, have a special place in American economic history. The first textile mill in America, for example, was made possible by two men risking their capital in a partnership. Success was far from certain. Partnerships—then as now—were for risk takers, not coupon clippers.

Today, independent oil companies, for example, get most of their funds from limited partnerships. In 1985, 48.5 percent of the expenditures on U.S. oil exploration and development, producing 35 percent of the crude oil produced that year, were financed through limited partnerships.

Partnerships today also finance research and development that will affect this nation for decades. One company—one company alone—has produced a medicine that permits growth deficient children to attain the physical stature and development normal for their age, a blod-clot dissolving agent with great promise for heart attack patients, an immune system protein that is believed to stimulate the body's natural defenses against viral and cancer cell activity, and an agent with the potential for destroying cancer cells without measurably affecting healthy cells.

Partnerships are creative, innovative, and entrepreneurial. No one ever left a partnership with a golden parachute worth millions of dollars. Some left poorer; some left richer. What they all had in common was a willingness to take a chance.

To date, VMS has completed three participating mortgage partnerships. Two are currently traded over the counter, and the third—which closed earlier this month—is expected to be quoted on NASDAC within six months. In the aggregate, over $310 million of capital has been invested by more than 25,000 investors with a minimum investment of $1,000.

These three mortgage programs are similarly structured to preserve capital and to provide quarterly cash distributions, appreciation, and liquidity. These funds allow average investors an opportunity to gain returns on investment grade properties, opportunities previously available only to major institutions and wealthy individuals.

I hope the committee and its staff will review the case studies in our written testimony. Tax policy obviously has consequences in the real world. The tax policy you are reviewing has permitted partnerships to finance housing for Americans of all income levels, biomedical research and development, energy exploration, and a host of other valuable activities.

As you review the appropriate tax treatment of MLPs, we would like to urge that great care be exercised to retain the important distinctions between MLPs and all other partnerships.

In our judgment, any Congressional action that further undercuts any stability and certainty still remaining for the investing public, after the Tax Reform Act of 1986, would be extremely detrimental for those of us who are working to raise new equity capital today.

Finally, let me urge the subcommittee to resist retroactive changes which may balance the books but are so counter to our concept of fair play. Contracts, agreements, and investments entered into in good faith like rules of the game should not be retroactively changed.

Mr. Chairman, we want to be helpful in supporting sound tax policy. We believe good tax policy produces solid social and economic results. Thank you very much.

Senator BAUCUS. Thank you, Mr. Cohen.

[The prepared statement of Mr. Cohen follows:]

TESTIMONY OF MR. LAWRENCE A. COHEN
FIRST VICE PRESIDENT, VMS REALTY PARTNERS
ON BEHALF OF THE INVESTMENT PARTNERSHIP ASSOCIATION

My name is Lawrence A. Cohen. I am the First Vice President of VMS Realty. I appear here today on behalf of the Investment Partnership Association (IPA). The IPA is the national organization of partnership investors and sponsors. Most sponsors of public partnership programs being offered to investors today are members of the IPA. Our members include, for example, Integrated Resources Inc., JMB Realty Corporation, Southmark Capital Corporation, E.F. Hutton & Company, Inc., Merrill Lynch, Hubbard, Inc., Angeles Corporation, VMS Realty Partners, Public Storage, Inc., and Silver Screen Management together with many of the major law firms, accounting firms and other businesses serving this industry.

The IPA serves as the primary spokesman for the partnership industry and through our members and consultants, provides technical support to both industry and government.

My testimony today will highlight the role of partnerships in attracting investment capital and in creating equity participation by both large and small investors. I will review the need for exercising care in considering legislative changes affecting both traditional partnerships and master limited partnerships. Most importantly, the Investment Partnership Association strongly urges that existing investments not be subjected to retroactive changes that significantly alter the economic rationale for such investments. In addition, we urge that great care be exercised to retain the important distinctions between publicly traded partnerships and all other partnerships. Last, but by no means of least importance, I am here today to express the Association's strong commitment to working with the

Committee in developing solutions to any technical and compliance problems that may exist in the case of master limited partnerships.

EVOLUTION OF MLPs AND THEIR ROLE

In late 1980, the first master limited partnership (MLP) was publicly offered by Apache Petroleum Company. MLPs grew slowly through 1985 and consisted mainly of oil and gas programs, a few real estate partnerships and a few timber programs. One of the unique features of an MLP is that, unlike the ordinary limited partnership, it provides its partners with the ability to purchase or sell partnership interest on an established securities exchange. MLPs are thus a convenient and effective entity for holding income producing assets readily valued in the market place. MLPs have become attractive to investors wishing to make equity investments which produce current distributions of income. Accordingly, income producing assets can be placed in an MLP and offered to the public at their full fair market value.

MLP holders obtain the right to receive a relatively high yield on their investment as well as the ability to sell that interest for cash at any time. Conversely, the utility of MLPs is limited under the passive loss rules adopted in the 1986 Tax Reform Act, generally barring current deductions for passive losses. It is generally disadvantageous for MLPs to incur indebtedness since the payment of interest and repayment of principle will reduce the ability of the MLP to distribute income to partners. Moreover, partners may be precluded from currently deducting any losses (in part consisting of interest payments) incurred through an MLP.

The relative advantage of MLPs is the availability of a partnership investment that is liquid. This advantage inures to the benefit of each partnership holder and to our economy in general. From an economic standpoint, MLPs are advantageous in that they attract equity capital from investors seeking income that is currently distributed. The income distributed is then taxed to individual partners.

On the other hand, under current law, those who invest in corporations may proceed in a very different way. To reduce the burden of our two-tier tax system that taxes income once when it is earned by a corporation and once again when it is distributed in the form of dividends to shareholders, the strategy described below may be followed. A corporation may borrow substantial amounts of money to finance its operations. By borrowing funds as opposed to securing additional equity investment, the corporation can enhance the net return on existing equity and treat the payment of interest on borrowed funds as a deductible expense as opposed to a non-deductible dividend payment for additional equity investment.

Consequently, corporations have increasingly been leveraging their investments through debt financing which may make their long term financial position more precarious. Corporate borrowing has resulted in reduced corporate tax payments through the allowance of the deduction for interest paid on such debt. Often the payment of interest is to tax exempt entities such as pension funds, endowments or qualified foreign investors. It is therefore not unreasonable to question whether any significant change in Federal income tax receipts would occur in the event the pass-through tax status of MLPs were to be changed. We are convinced that as a practical matter, although only taxed once at the partner level, MLP income may be subject to roughly the same amount of tax as income earned through a conventional corporation and subsequently distributed to its shareholders under the present two-tier tax system.

The IPA therefore urges that no changes in the basic pass-through tax status of MLPs be made at this time. Under the Tax

Reform Act of 1986, the Treasury Department has been directed to review the entire structure of Subchapter C and to submit its findings and recommendations to the Congress by the end of 1987. Until that comprehensive review of Subchapter C and its relationship to the various pass-through entities under the Code is completed, we believe any change runs the risk of being at odds with the overall conceptual framework of the general rules for taxing business and investment income that may be formulated and approved within the next twelve to eighteen months.

We believe sound tax policy requires patient and thoughtful review. Hasty action in the context of a Reconciliation effort by the Congressional tax writing committees on a matter that is so basic to our tax system would be very imprudent in our judgment.

THE IMPORTANT ROLE OF PARTNERSHIPS IN ATTRACTING CAPITAL

As a form of business organization, the partnership has always appealed to Americans seeking to form new ventures. It is intensely entrepreneurial and accommodates the self-reliant, do-it-yourself spirit of individuals. Identify an economic need and the partnership provides an immediate business structure to cultivate the opportunity. At the same time, the partnership satisfies the American sense of community, joining together for the common good.

The partnership is uniquely designed to unite talent and resources productively and efficiently. Less cumbersome than a corporation, the American partnership has been able to accumulate funds quickly to start up an enterprise at the optimal moment. At the same time, its simple, direct structure has allowed the entrepreneur managerial control over all phases of his operation, resulting in knowledgeable integration of activities. And it has proven itself adaptable to almost any business venture, undertaking crucial projects inappropriate for other kinds of organizations.

Partnerships fall into 3 categories -- general and limited partnerships and master limited partnerships. General partnerships, as the name implies, are entities within which each partner has a general right to share in both profits and losses of the partnership. These rights are unlimited and each general partner may be called upon to satisfy the full amount of any partnership indebtedness or other obligation to outside parties. Within the partnership, the general partners will usually be obligated to one another to the extent of their economic interests. For example, a general partner with a 10% partnership interest may be entitled to 10% of all profits and may be liable for up to 10% of all partnership losses. If such a partner is called upon by outside parties to satisfy a partnership obligation greater than his 10% share of the obligation, this partner will generally have a right to seek contributions from other general partners to the extent of their partnership interests.

A limited partnerships' economic arrangement is structured so that it is composed customarily of one general partner (required to meet a substantial net worth requirement by the IRS) and any number of additional limited partners whose liabilities are limited under the partnership agreement to a fixed amount (generally, not in excess of their fixed investment in the partnership) and such limited partners participate in the income and losses of the partnership as provided under the partnership agreement. In the most basic limited partnership arrangement, limited partners will contribute in excess of 95% of the capital utilized by the partnership and in exchange will be allocated, in the aggregate, an identical amount of income and loss from the partnership. This type of entity has been utilized broadly as a means of raising large amounts of capital for investment in real estate, oil and gas, entertainment. equipment leasing, and similar enterprises. This type of partnership can be used for small private offerings of less than 25 investors and can also be registered with the Securities and Exchange Commission and offered to thousands of individual investors through registered securities representatives. Such partnership interests, once purchased, are generally held for a long period of time so that the partnership can realize maximum income or gain from the underlying investment. Individual limited partners are generally unable to transfer these partnership interests except where the general partner has made special arrangements to assist in securing other investors to permit a limited partner to transfer his or her interest. This is frequently done to accommodate limited partners who encounter economic hardship.

For the Committee's information, The Investment Partnership Association presents a few brief case studies detailing the important contributions of several successful partnerships.

I strongly urge the Committee and its staff to review these case studies. All too often we separate technical considerations of tax policy from practical application. The tax policy considerations your Committee will review are integrally related to adequate funding for affordable single family and multi-family housing for all Americans, biomedical research and development, energy exploration and development and other socially and economically desirable undertakings. The following case studies are offered to illustrate the success of four partnerships in meeting important needs.

PARKER & PARSLEY PETROLEUM PARTNERSHIPS

The United States currently imports 41 percent of the crude oil and refined product it consumes. The situation leaves us in a vulnerable position unless energy conservation and domestic production are to be increased.

Oil and gas exploration and development are among the riskiest of business ventures. Fortunately, partnerships have proven to be an economical way to share the risks. One of the most successful of the independent oil companies, Parker & Parsley Petroleum of Midland, Texas, has relied upon partnership investment to adopt advanced, specialized, and in some cases unique techniques of prospecting, evaluating, drilling, completing, and operating oil and gas properties. From 1981 through 1987, Parker & Parsley engaged in 16 limited partnerships to finance its developmental drilling activities in the proven Spraberry Field and in the Cherry Canyon Field. During that time 568 wells were drilled, 96 percent of which became commercially productive and are expected to produce for 25 to 35 years.

Most of the capital that funds independent oil companies actually comes from limited partnerships. In 1986 the independents accounted for 48.5 percent of the $33 billion spent on oil exploration and development in the United States. The production that resulted contributed 35% of the nine million barrels per day of crude oil this country produced in that year, including the Alaskan North Slope. Such limited partnerships are a traditional business structure heavily utilized in energy development. The ability to successfully attract capital through partnerships engaged in the production of oil and gas must be continued. It is this ongoing investment that will promote continued competition in this industry and will augment our effort to increase our domestic oil and gas reserves.

1775 HOUSING ASSOCIATES

1775 Housing Associates is a real estate limited partnership formed to develop, construct, own, maintain, and operate a 255-unit 11-story brick-faced apartment building completed in 1981 and located on 126th Street in the East Harlem Triangle Urban Renewal Area of Manhattan. Over 10,000 families applied to live in this low-income housing project, which was built in conjunction with the program established by Section 8 of Title II of the Housing and Community Development Act of 1974. Two residents were interviewed on February 6, 1987 about their life at 1775.

Mrs. Wille May Livingston is a tenant of the housing project. "I always told everybody this building's a miracle to me. The place where we came from --115th and Lenox Avenue -- is a disaster area. When you dressed to come out with your kids to go to church, you walked over garbage, over people lying in the hall. And you heard everything that is unpleasant to the mind and the ears on your way. We weren't used to that. My kids wanted to know why all the people were sleeping on the street. They couldn't understand the crowd on the corners all day long. And the tragedy, seeing people abused in the street, abused on top of the roof. I had a baby, and on the sixth floor, it was so hot, he used to suffer from dehydration. And the doctor said he needed air. How could you air condition a seven-room, run-down tenement place, the windows were broken, the doors hanging off? Maybe hot water one month, and without for two months. The heat was the same way. The elevator had been out ever since we moved in.

"And then when you get a place like this, that's when you appreciate it. There's nothing that I wouldn't do to keep this

"The partnership said, 'we're going to try and help people to help themselves.' All they did was invest the money to make sure the people could get a decent place to live and ask for a return on their investment. Instead of taking every penny from a project they put money back into the community."

During the ten years in which Section 8 development was authorized, 13,589 single or multi-building projects consisting of 841,870 rental units were scheduled to be either built or substantially rehabilitated across the country through this joint scared to go. You meet other families in the building. They are glad about the building and are proud to be here. We tell the young people the value of these places. This will get to be your home later on."

Ms. Alice Kornegay, resident social worker: "We just all come in as a big family. So you have kids going to parochial school and public school and private school elsewhere who live right here. We have teachers in high school and college living here, able to make sure the young people follow in their footsteps. We have elderly and disabled. Most people are working.

"We thought that we wanted an urban renewal area. We wanted a human renewal area, to deal with the human side of people. That we don't take them from one rundown slum, and put them into another rundown slum. A lot of these people could have been homeless people today. I know what it is to look at vacant land, and nothing is happening. So you have to spend money.

"The partnership said, 'we're going to try and help people to help themselves.' All they did was invest the money to make sure the people could get a decent place to live and ask for a return on their investment. Instead of taking every penny from a project they put money back into the community."

During the ten years in which Section 8 development was authorized, 13,589 single or multi-building projects consisting of 841,870 rental units were scheduled to be either built or substantially rehabilitated across the country through this joint effort between the United States Government and private enterprise. By the beginning of 1987, 786,393 apartments were occupied by families who had finally found adequate housing and a measure of human dignity. The great majority of these projects were undertaken with partnership investment.

SILVER SCREEN PARTNERS

Since the 1970's, limited partnerships have played a significant role in providing funds for the production and distribution of motion pictures. A great variety of the finest and most popular films -- from Star Trek to Saturday Night Fever to The Big Chill -- have been brought to millions of Americans through partnership investments. While earlier movie partnerships were tax-advantaged in structure, more recent ones are geared primarily to generate income. Whatever the structure, these partnerships enable a wide range of investors to participate in an industry otherwise closed to them. These partnerships expand the opportunities for jobs in one of our most labor intense industries. These investors also make it possible to share the financial risks of bringing to the public an unpredictable but beloved entertainment product.

One of the most successful series of movie partnerships is the Silver Screen Partners. Since 1983, 85,239 investors have contributed $576 million to finance Silver Screen motion pictures. Silver Screen's three offerings are the three largest film financing partnerships ever assembled. Silver Screen partnerships are designed to protect capital and provide income and appreciation. Capital is used exclusively to finance 100 percent of a film's production cost. Among the movies supported by Silver Screen partnerships are The Color of Money, Outrageous Fortune, Down and Out in Beverly Hills, Ruthless People, and Tin Men, as well as a number of Walt Disney Pictures films, both live action and animated, designed for family audiences. Silver Screen Partners has been able to provide many new jobs for the entertainment industry as well as many widely acclaimed films for the movie going public.

GENENTECH, INC.: BIOTECHNOLOGY

Harnessing genetic processes for man's benefit requires both the genius of microbiologists and the foresight of investors willing to undertake the risk inherent in pharmaceutical research. Founded in 1976, Genentech, Inc. has relied upon three limited partnerships to finance the research and development of four significant biotechnology products. For example, Protropin is currently the only hope of children suffering from growth deficiency to attain a physical stature and development normal for their age.

Genentech's other biotechnology products whose research and development are being funded by limited partnerships are equally important. Activase (t-PA), a blood clot-dissolving agent for cardiovascular diseases, is undergoing its clinical trials for treatment of heart attack. To date, nearly 4,000 heart attack patients have been treated worldwide, and for 70 to 80 percent of those patients, the clots causing the heart attack have been dissolved. Gamma Interferon, a protein of the immune system that is believed to stimulate the body's natural defenses, is presently undergoing clinical trials for anti-viral and anti-cancer activity. Tumor Necrosis Factor (TNF) shows potential for destroying cancer cells without measurably affecting healthy cells, thus providing a significant advantage over conventional chemotherapeutic agents.

Barely a decade old, the biotechnology industry consists of some three hundred companies that have developed about three dozen products that are radically transforming medical and agricultural horizons. For Genentech, the limited partnership supplies a business structure through which an adequate level of funding can be obtained while the large investment losses inevitable in the early stages of research and development can be absorbed. Biotechnology is another American revolution that partnership investment has helped nurture.

PROCEED WITH CAUTION ON FUTURE LEGISLATION

As a result of legislation previously enacted by Congress, partnerships are no longer used to develop transactions which would be classified as primarily tax motivated. Moreover, recent legislative changes have dramatically circumscribed taxpayers' ability to shelter income through partnership investments.

Most, if not all, of the potentially abusive applications of partnerships were dealt with by Congress (and by Treasury in subsequent regulation) in earlier tax legislation. For example, in the Deficit Reduction Act of 1984 (the "1984 Act") Congress adopted stringent allocation rules in order to prevent artificial shifting of tax benefits between partners with respect to pre-contribution gain or loss. More recently, Treasury has furthered Congress's intent by promulgating comprehensive regulations to ensure that partnership allocations have substantial economic effect aside from their intended tax effect. As a result, taxpayers can no longer use partnerships to shift income and deductions in a manner at variance with economic reality.

Another legislative change preventing abusive use of partnership is the expansion of the original issue discount rules for deferred-payment transactions involving property. Taxpayers can no longer artificially inflate the purchase price of property and thereby convert interest into loan principal. (Although this abuse was not limited exclusively to partnership transactions, its use was frequently associated with them.)

TAX ORIENTED INVESTMENTS SIGNIFICANTLY REDUCED UNDER THE TAX REFORM ACT OF 1986

The non-abusive use of partnerships as vehicles for sheltering unrelated income of investors has been effectively eliminated under the Tax Reform Act of 1986 (the "1986 Act").

The leading tool of the 1986 Act is the passive loss limitation rules. These rules treat a limited partnership interest in a trade or business as conclusively passive. As a result of these provisions, partnership losses can no longer be used by partners to offset unrelated positive income. Moreover, additional tightening was achieved through amendments to the investment interest rules. Under the 1986 Act, investment interest in excess of income generated by passive investments cannot be used to offset income from active sources. Thus, the new rules limit the deductibility of investment interest to the extent income is generated from the investments with respect to which the indebtedness was incurred.

The focus of the 1986 Act passive loss rules was on the elimination of investments structured to generate losses for non-participating investors that could be used to offset other positive sources of income. While there is concern about the long term ramifications of the 1986 Act changes on certain investment such as low income housing where rates of return are not sufficient to attract capital, all concur that these changes have addressed the "sheltering" concern so often voiced about partnership losses.

In addition to these limitations on the use of partnerships, Congress' repeal of the General Utilities doctrine provides an additional constraint on the use of partnerships as a means of avoiding imposition of the corporate level tax. Although the 1986 Act's lower maximum individual tax rate (which is lower than the corporate rate) caused initial concern that it would stimulate entity conversions from corporate to partnership form, with the repeal of General Utilities, such conversions are in most cases not economically feasible because the tax now would be imposed at the corporate level upon liquidation.

FURTHER CHANGES MUST RESPECT EXISTING INVESTMENTS

In many instances, the 1986 Act imposed retroactive changes on the treatment of various investments. For example, investments in limited partnerships made prior to the date of enactment were subject to the new passive loss rules, even though at the time those investments were entered into, the existing law provided for different tax treatment. The effect of these retroactive changes is to alter the rules in the middle of the game and thereby effectively deny the benefits anticipated at the time such investments were entered into. This retroactive legislation has badly shaken investor confidence. Moreover, the imposition of tax on transactions entered into in reliance on prior law, where the law has been retroactively changed, raises serious constitutional questions that have not yet been fully addressed.

After the retroactive changes made in the 1986 Act, we would hope Congress would eschew additional retroactive changes to the rules governing treatment of master limited partnership investments. Specifically, taxpayers who have entered into such arrangements in reliance on the treatment of partnerships as pass-through entities should not be severely disadvantaged by a subsequent denial of such status.

In addition to problems with investor uncertainty which have resulted from the retroactive application of several provisions in the 1986 Act, there remain many unanswered questions which have led to problems in restoring investor confidence. While some of these uncertainties are typical of investor reaction to any change in the tax laws, others appear unique. I would like in particular to focus on a provision contained in the passive loss rules, section 469(k)(3), which delegates an unprecedented broad grant of regulatory authority to the Treasury to recharacterize passive income as portfolio income. With this authority the Treasury is permitted to ignore the statutory classification of income made by Congress whenever the Treasury determines that such classifications are not appropriate.

The existence of this authority has generated ongoing investor uncertainty. Unlike other regulatory issues that may be resolved when the passive loss regulations are eventually issued, this grant of authority can be exercised by the Treasury at any time and under virtually any circumstances. Its existence is particularly unsettling in light of the authority contained in section 7805(b) allowing the Treasury to issue such regulation retroactively.

We would strongly recommend that this grant of authority to the Treasury be removed. Its existence makes it virtually impossible to fully apprise investors of the tax treatment of any investment involving a limited partnership.

Finally, we wish to reiterate our strong concern that any tax changes regarding pass-through entities be part of a comprehensive review of these entities and their relationship with the rules of Subchapter C. Changes should not be made in isolation, just to "get some money."

Thank you.

Senator BAUCUS. Gentlemen, in your view, are there tax advantages in organizing as an MLP, compared with a corporation?

Mr. NEAFSEY. Let me take a shot. You know, obviously——

Senator BAUCUS. Yes or no? Just basically; are there tax advantages?

Mr. NEAFSEY. There is the elimination of double taxation.

Senator BAUCUS. Do most of you agree with that?

Mr. MOFFETT. Yes.

Mr. SANDLER. Yes.

Mr. COHEN. Yes.

Senator BAUCUS. My second question is whether you have substantial agreement or disagreement with the table that Secretary Mentz included in his testimony. I am sure you haven't had a chance to see the table; let me just summarize it for you. It describes the percentage increase in the after-tax rate of return of an investor conducting business in partnership rather than corporate form, and breaks this down into various categories: equipment, structures, inventory, land, and overall. And the after-tax advantage, the rate of return before the Tax Reform Act for those various categories was roughly 7 percent, 10 percent, 16 percent, 16 percent, and 11 percent.

Then after the TRA, it rises to 19 percent, 23 percent, 24 percent, 24 percent, and 22 percent. It is showing even additional after-tax advantages since the Tax Reform Act.

I am wondering if you basically agree with this table or not.

Mr. SANDLER. Mr. Chairman, I would like to make just a few comments on that.

Senator BAUCUS. Sure.

Mr. SANDLER. From what I can see on the table, there may be an erroneous assumption that two-thirds of your corporate structure is equity and only one-third is debt. We are talking of publicly traded corporations; I am not sure that is true.

The other comment I would make would be on the revenue figures that Mr. Mentz has quoted, that we would either lose or find ourselves losing over the next three to five years——

Senator BAUCUS. That is a different issue, though.

Mr. SANDLER. All right. We can't get the assumptions for those either.

Mr. NEAFSEY. Mr. Chairman, if I may comment? I think there is one fundamental premise here, and that is that an MLP financing is an alternative to equity. That is the underlying basis behind constructing a table such as this; and I would submit that at the margin, equity funds, raising incremental funds through the common stock is simply unavailable to the vast preponderance of cases to which the MLP financing was applied. I think it is a bit of a red herring.

Senator BAUCUS. But basically, do you agree or disagree with this table?

Mr. NEAFSEY. I can't comment on that.

Mr. MOFFETT. One thing I would be concerned about, Mr. Chairman, is the very point that we made that the income that is made by a partnership has to be distributed. In other words, it is distributed or the partnership is taxed on it, anyway.

Senator BAUCUS. With all due respect, though, that is another issue, too. I am trying to establish whether you generally agree with the percentage rate of return of a partnership holder of an MLP compared with——

Mr. MOFFETT. Can I make myself clearer, Mr. Chairman?

Senator BAUCUS. Sure.

Mr. MOFFETT. If you hold a stock and you own the stock and the equipment and all of the assets of the corporation gain value, it is an asset play.

Senator BAUCUS. Sure.

Mr. MOFFETT. You buy the stock and you sell the stock; and you are taxed on whatever the gain is. Do you understand, sir? As opposed to the fact that these assets are not held like that in a master limited partnership; all the revenue is distributed. So, my point is—and I think it is the same point, Mr. Chairman—that if you are being taxed as a corporate shareholder, you are being taxed on the asset appreciation, whether the stock goes up or down, as opposed to that in an MLP where you are being taxed on your yield. And that is the point I was trying to make, sir, because I am not sure that has been taken into consideration here. And that is a very big difference between the way a master limited partnership is taxed to the investor.

Senator BAUCUS. A basic question that often arises is the degree to which an MLP is a substitute for equity financing. I would like your views regarding the degree to which there is a tradeoff of MLP capital financing compared with equity capital financing compared with debt. Can you give me a rough idea of your best judgment?

Mr. MOFFETT. I would like to take a shot at that. Many of the things that were done—the two instances that I discussed with you—where you are going in and buying a business that you have to have equity to take over, there is no way you could use the corporate share to sell in order to reincorporate that vehicle because it is basically a——

Senator BAUCUS. If you don't mind, in the interest of time, let me ask the question differently. Assuming MLPs were taxed as corporations, then would MLPs be utilized as much? And to the degree they would not be utilized as much, what other form of equity financing would most likely be used?

Mr. NEAFSEY. Let me speak directly to the question. We issued $200 million worth of MLPs in December of 1985. If the MLP route had not been available to us at that point in time, we would never have issued equity to finance that $200 million worth of incremental capital because of its dilution characteristics. In fact, we sold MLP units while we were in the middle of a stock repurchase program; so we were buying, not selling, equity. If the MLP had not been available, we would have raised the incremental capital through the debt route; and that is exactly what we did in 1986. So, debt is the substitute for an MLP.

Mr. COHEN. I would like to answer that as well and say that an MLP is in fact equity. It is not a substitute for it. In fact, many of the roll-ups from partnerships into an MLP would never take place if an MLP was not available, and they would not be able to raise additional equity in their——

Senator BAUCUS. My question again is: If MLPs were treated as corporations, in each of your various industries for tax purposes, what is the degree to which you would still utilize MLPs? And if not, what other form of capital financing would you use?

Mr. COHEN. I think you would also see the continuing abuse of the partnership—the nontraded partnerships—which had been used for years.

Senator BAUCUS. I am sorry; I missed that.

Mr. COHEN. The continued use of the partnership vehicle, maybe not traded over a securities exchange, but there are many assets strictly in investment partnerships which will continue in the partnership format without the liquidity feature.

Mr. SANDLER. We would not go into a corporate format.

Mr. COHEN. We would not go into the corporate format.

Senator BAUCUS. All right.

Mr. COHEN. The real estate people would go to partnerships—nontraded partnerships.

Senator BAUCUS. So, the real estate industry would go to REITs or other forms of pass-through organizations if MLPs were not available as they are today, that is for the purpose of computing the tax consequences?

Mr. COHEN. Yes, Mr. Chairman, I see the point you are making; however, I would disagree with that, sir. We looked seriously at REIT status before we rolled up into an MLP and rejected it. We would not go into it, an REIT status. We would have stayed just the way we were in private partnerships.

Mr. SANDLER. I would like to answer on the REIT issue that the market has reacted. The provision has been in the Tax Code for a number of years; it has never really been used that often. The PARS is clearly a preferable vehicle to the REIT because of the inflexible manner in which the REIT can apply, as well as the market perception that the REIT does not meet the requirements of the post-partnership vehicle.

Senator BAUCUS. One other question before I turn this over to Senator Matsunaga. Why have MLPs suddenly become more widely available? Another table that Secretary Mentz showed us is how there has been a substantial increase in the last several years. What has caused that in your view?

Mr. MOFFETT. One of the reasons is because the other alternatives that were available to us to raise the funds have disappeared as a result of the 1986 tax bill, and the anticipation of it. So, the MLP is a creation to try to come up with another venture capital form that replaces really the passive loss at-risk, passive income type of vehicles that were eliminated by the 1986 Tax Reform Act.

Senator BAUCUS. That goes to tax consequences.

Mr. COHEN. Well, there are competitive consequences Investments today are competing against mutual funds, stocks, bonds, other types of investments.

Senator BAUCUS. But are there nontax consequences which explain the rise of MLPs in the last several years?

Mr. NEAFSEY. I think, as I explained in my testimony, the MLP is uniquely suited to the risk/reward characteristic, at least of our industry. And one of the things that has caused the explosion of MLP interests in the last few years really has been the computer, as was brought out in Mr. Mentz's testimony. If it were not for the computer, you could not have publicly traded limited partnerships. It simply would be unacceptable. It would have been unmanageable from a corporate standpoint. On that point, you must recognize that some of the questions that went back and forth, we have to be extraordinarily conservative in the way that we apply the tax rules to our partnerships because the last thing in the world you would want is to have 10,000 or 20,000 or 30,000 partners who, upon audit, found that you were overly aggressive in your tax treatment, so the Treasury is not being negatively benefitted as a result of publicly traded partnerships.

Senator **BAUCUS**. Senator Matsunaga?

Senator **MATSUNAGA**. Thank you, Mr. Chairman. Mr. Moffett, you testified that your company expects to pay 50 percent more Federal income tax as a result of conducting your business in the MLP form. Would you expand on this?

Mr. **MOFFETT**. The main reason for that is that we own a major portion of our MLP units; and therefore, the distribution of that income, as it relates to the partners since we own 80 to 85 percent of our partnerships, relates to our ownership of the MLP Treasury units. It is the idea that we are being forced to distribute the income because we have to have the yield or these partnerships won't be valued by the marketplace. And since we own a substantial portion of those ourselves—80 to 85 percent—that is what creates the taxable income for us.

In the old corporate vehicle, you take income and you reinvest the income, the whole idea is to build the asset play. It is completely different in an MLP because you have to make that income available for the yield or your security is not a yield security. And that is the only reason why it was purchased. If it falls, you can watch the price of your stock.

We have a form of guaranty on our MLP distributions for five years. We committed that as a corporation because, if you don't do that, when people announce that their yields are dropping or their distributions are dropping, people immediately decimate the price of the unit. So, it is the distribution of the cash that is forced by the MLP, as opposed to the corporate structure; and we own a major portion of those.

In my written testimony I explain how if we had borrowed money to make our acquisitions we would have actually paid less corporate tax because of the interest deduction.

Senator **MATSUNAGA**. And even under such circumstances, where you need to pay 50 percent more in taxes, you would still prefer MLPs to incorporation?

Mr. **MOFFETT**. Mainly, Senator, because the kind of investments we have made with the equity we have raised from this just wouldn't be available in the other vehicle. We have been able to see growth in our company. We have been able to double our oil and gas reserves from 600 billion cubic feet of gas to 1.1 trillion cubic feet of gas because we were able to buy a commodity that was out of favor. We were buying oil when everybody was selling because we had this creative vehicle to be able to let people have a yield so they could hold this security until the commodity came back into favor. If you didn't have that yield, then people wouldn't buy the commidity. They would wait until it came back in favor; but with the creation of this yield type security, we were able to get people to invest equity money into commodities that were currently out of favor.

Senator MATSUNAGA. Now, Mr. Neafsey, you testified, as I understand it, that your decision to employ MLP was motivated by a desire to raise new capital and not be a desire to avoid Federal taxes.

Mr. NEAFSEY. Correct.

Senator MATSUNAGA. How would you respond to the Treasury's argument that the dramatic increase in MLPs since 1983 will lead to the erosion of the corporate tax base?

Mr. NEAFSEY. I simply don't think it is true. I don't think it is the right case. I think all of the numbers that were suggested by the Treasury this morning and in other testimony before the House are fundamentally based on two premises: number one that the growth of MLP units is going to continue along the same lines as it has since 1982 or 1983; and number two, that the alternative means of raising that capital is not done through a hybrid vehicle which is uniquely suited to the risk/reward characteristics of the project that you are trying to finance, that the alternative would be through the sale of common stock or through normal equity channels. I think—as has been testified by all of these gentlemen, including myself—when put with the question what would you do if an MLP were not available, none of us suggested we would raise money through common stock. Some said debt, such as myself. Others said partnership units. Others said other forms of unique securities.

But the alternative of common stock financing is simply not a viable alternative. There is too much dilution. So, the disincorporation of America concept, I think, is a red herring.

Senator BAUCUS. Mr. Moffett, you are a general partner; correct?

Mr. MOFFETT. Yes, sir. FMI is. Yes, sir.

Senator BAUCUS. Are you incorporated?

Mr. MOFFETT. Yes, sir.

Senator BAUCUS. Why are you incorporated as a general partner?

Mr. MOFFETT. We, the corporation, serve as the general partner for the master limited partnership. Now, let me be sure I understand your question. We, Freeport-McMoRan, Inc., were the sponsorship of this partnership.

Senator BAUCUS. What, if I might ask, is your liability as an incorporated general partner?

Mr. MOFFETT. As an incorporated general partner?

Senator BAUCUS. Yes.

Mr. MOFFETT. Our liabilities are that we are who the debtors look to, et cetera. Now, nobody has ever had a Manville-type of catastrophe, or a Union Carbide type of catastrophe in an MLP. And when that happens, of course, there are going to be some interesting—you know, people in the legal profession can sue you for anything.

We have not tested a Johns Manville/Union Carbide type of catastrophe.

Senator BAUCUS. But Johns Manville and Union Carbide were not MLPs.

Mr. **Moffett**. No, sir.

Senator **Baucus**. They were corporations.

Mr. **Moffett**. That was my point, Mr. Chairman.

Senator **Baucus**. I am just trying to determine the degree to which your liability as a general partner is limited in the corporate form as opposed to unincorporated.

Mr. **Moffett**. To my knowledge, without the aid of counsel, I am not aware of any reason that we would have to say that we have any less liability than an individual would have as a general partner, just because we are a corporation.

Mr. **Neafsey**. If I could pitch in here just one minute? Any general partner has got to demonstrate economic substance. So, the general partner in any master limited partnership has got to put up a substantial amount of wherewithal, and that is at risk.

Senator **Baucus**. Sure.

Mr. **Sandler**. Mr. Chairman, I would like to add to that.

Senator **Baucus**. Yes?

Mr. **Sandler**. I am personally, in my individual capacity, a general partner.

Senator **Baucus**. Right.

Mr. **Sandler**. And we, my partners and I, are at risk, I promise you. I worry about it all the time.

Senator **Baucus**. Yes. I can tell by the tone of your voice that you do think about that.

I guess I am really just trying to get at the basic question that Treasury and others have posed, that is, there really is no difference between an MLP and a corporation. That is, if we are not going to have integration, we shouldn't have integration. If we have a two-tier system, then we should have a two-tier system; if we are not, we shouldn't.

But the present Tax Code says that there will be a two-tier corporate systems; and if an organization is organized like a corporation, it ought to therefore be taxed on a two tier basis. To be candid with you, I sense that by far the prevailing advantages of MLP organization are tax advantages.

And I am trying to better understand what the nontax advantages if any in an MLP organization. That is not to say whether or not we would change the taxation of the MLPs; I am just trying to get at the nontax advantages.

Mr. **Cohen**. A substantial number of MLPs, first of all, are roll-ups. We take the existing partnerships which are already integrated—the same taxes, a partnership—and roll them up into a master limited partnership. The advantage of the master limited partnership clearly is liquidity.

And where liquidity fits in is this risk/reward analysis. Nonliquid assets, which cannot be easily sold, should be priced at a discount, as compared to a liquid asset. And in going out to the market and in trying to obtain the capital that is necessary for the roll-ups, it is very important to have that liquidity in order to be able to price that unit and to provide the yield to the investor.

Senator **Baucus**. How much is the advantage versus the——

Mr. **Cohen**. These were already in partnerships.

Senator **Baucus**. I am sorry?

Mr. **Cohen**. These were already in partnership form. So, there is no added benefit in financing the liquidity.

Senator **Baucus**. Sorry. These were already what?

Mr. **Cohen**. These were roll-ups of existing partnerships.

Senator **Baucus**. You didn't go out and get additional partnership interests as part of the roll-up?

Mr. **Cohen**. They would be through the issuance of a master limited partnership.

Senator **Baucus**. Therefore you did?

Mr. **Cohen**. Right.

Senator **Baucus**. As part of the roll-up?

Mr. **Cohen**. Typically, as part of the roll-up, getting additional equity——

Senator **Baucus**. And there are tax advantages in getting those additional partnership interests as part of the roll-up?

Mr. **Cohen**. However, there is not a revenue loss in the sense that very often that what is happening in the roll-up is that very often what is being replaced is equity for the debt. The partnership money would be coming in to replace debt on properties to attract investment capital for properties that would not otherwise have an opportunity to raise that capital.

Mr. **Neafsey**. May I speak to this issue because I think there is a very fundamental difference between a corporation with respect to other than this taxation issue that, as has been testified here by others, with a master limited partnership you are obligating yourself as the general partner or as the partner to distribute essentially all of the cash flow that comes into the entity.

Senator **Baucus**. Right.

Mr. **Neafsey**. That is very different from a corporation, and that results in very different pricing in the capital markets. For example, in an oil company if you were to generate, let's say, $3 of cash flow, typically by the time that would find its way through the corporate route, through the dividend route, to the original investors, they would be very lucky if they would see 25 percent or 20 percent of that $3. On the other hand, through the master limited partnership, with the exception of G&A and other expenses, they see all of it. And that creates a very different mindset and a very different appetite in capital markets for this type of security.

And it is driven by the notion that they are going to obtain that cash flow, and it is not going to be siphoned off for other corporate purposes. There are a number of investors—strangely enough—who are corporations that are nontaxable entities who invest in MLPs; and they get no benefit whatsoever of the elimination of double taxation because they are not taxable entities to start out with. But to them, just the flow of cash is very important.

Senator **Baucus**. As I understand it then, what has happened is that the development of computers has enabled a greater number of partnership interests to be developed so the interests can be publicly traded on the stock exchange. So, to the degree that that is the case, it seems just for the purposes of argument that liquidity advantages would still be there if we adopted, say, the Secretary's suggestion that demarkation between corporate form of taxation versus not would be whether the partnership interests are publicly traded.

That is, there are a lot of partnership interests that would not be publicly traded that would still be available. And I am wondering the degree to which the unavailability of publicly traded partnership interests would impede or prevent the raising of the kind of capital that your industries need and the kind of liquidity that your industries need.

Mr. **MOFFETT**. Mr. Chairman, let me speak to that. The venture capital formation structure where we have to go—How do you bring $600 million to the table? You have to have a vacuum cleaner out there to vacuum that money up. If you don't have a public entity that has liquidity so that the investment banking community——

Senator **BAUCUS**. Let's not worry about the vacuum cleaner. [Laughter.]

Mr. **MOFFETT**. But that is what it is. How can you gather the $1,000 investor or the $2,000 investor or the $5,000 investor to deal with him? You have to have this public security; you have to have the SEC type of regimentation because it is the only way that we can put venture capital together. And that is the whole point of my saying in my verbal testimony that we don't want to exclude the ability for investors in this country—the small investors. We don't want to make this a country in which only the rich can invest.

If you go to private partnerships, Mr. Chairman, you are going to have the $100,000 player who has the advantage because the amount of money it would cost us, without a public vehicle, to try to get this $1,000, $2,000, and $5,000 player so that he can put his money into the commodities and own a natural resource through a partnership interest, it would be implausible. So, what happens if you do what you talked about, Mr. Chairman, and have just the private partnerships out there, it means we have made the United States a country in which only the rich can invest. The small investor has no opportunity because, in order for an investor to have an opportunity to invest, he must have a way to meet the person who can do the investing.

There are a lot of doctors and lawyers and Indian chiefs out there who want to invest their money; but they don't have time to meet with a company. Imagine my having to meet with all of the 25,000 partners and convince them individually on a private partner basis without the SEC and the public capital formation available to us. It is just that simple.

Senator **BAUCUS**. Don't misunderstand. I think most members of this committee are trying to help individuals and business organizations raise additional capital so that we can compete. The fact of the matter is that I am a co-chairman of a group here in the Congress called The Congressional Caucus on Competitiveness; and one of the biggest problems we have in this country, as you know better than we, is our relatively higher real cost of capital in this country, compared to other countries.

Mr. **NEAFSEY**. You bet.

Senator **BAUCUS**. And we, as part of our organization, are trying to find ways to lower that disadvantage so that the American real capital costs are in fact lower. Part of the problem is our Federal budget deficit. So, as much as we are all sympathetic with MLPs as another financial vehicle, we also have another responsibility here, and that is the Federal budget deficit.

And in this next week, this committee is going to be charged with the responsibility of attempting to raise approximately $18 billion as part of reducing the Federal budget deficit. We are also cutting spending—before you jump to that misinterpretation. So, all this is part of the calculus; that is, how to reduce capital costs is a major goal. One component is the high Federal budget deficit and another is potential adverse tax consequences that may be visited upon MLPs. So, we are trying to balance the equities here and trying to find out what makes the most sense.

Mr. MOFFETT. Mr. Chairman, may I submit to you that if we are trying to solve the Federal deficit problem, the one way we are going to do it is a robust economy. And I will assure you, Mr. Chairman, that if we stop the venture capital formation in this country, the economy will not be robust.

So, if we are going to solve the Federal deficit problem, we are not going to do it with additional taxes. We must have a robust economy. Every economist agrees with that.

Senator BAUCUS. I appreciate that, but this Congress has also cut taxes; and that is part of the reason why our Federal budget deficit is as high as it is. I am not saying it is the sole reason, but I think most honest observers conclude that it is part of the reason, in addition to defense spending, that has caused the high Federal budget deficit that we now have. One more comment and then we are going to have to go to the next panel.

Mr. SANDLER. Mr. Chairman, may I just comment that we sympathize with your desire to raise revenue. I would suggest, however, that——

Senator BAUCUS. Or prevent the hemorrhaging.

Mr. SANDLER. Or prevent the hemorrhaging—either way—is a fair comment. But if you were to take Mr. Mentz's testimony at face value, the $215 million that he would either raise or prevent the loss of over the next three years, a good part of which has to do with a change in passive versus portfolio income, you are really not talking about a whole lot of revenue gain or prevention of hemorrhage if you were to treat MLPs as corporations for tax purposes.

I am not even sure that the Secretary's numbers are accurate. We have not been able to find out.

Senator BAUCUS. Thank you all very much. We appreciate your testimony. Our final panel consists of Mr. John Chapoton of Vinson and Elkins; Mr. Barry Miller of Andrews and Kurth; and Mr. Richard Cohen of Winthrop, Stimson, Putnam and Roberts.

Mr. Chapoton, welcome back.

STATEMENT OF JOHN E. CHAPOTON, PARTNER, VINSON & ELKINS, WASHINGTON, DC, ACCOMPANIED BY J. GREGORY BALLENTINE, PRINCIPAL, PEAT MARWICK MAIN & CO., WASHINGTON, DC

Mr. CHAPOTON. Mr. Chairman, thank you, sir. Let me say that my name is John Chapoton. I am a partner in the law firm of Vinson and Elkins. I am appearing here today on behalf of Goldman Sachs, Merrill Lynch, and ENSERCH Corporation. I am accompanied by Mr. Gregory Ballentine, who is a principal in the Washington office of Peat Marwick Main & Company, and was formerly with me at the Treasury Department.

A couple of statements were made earlier about the Treasury Department's prior position and I would just like to point out one aspect. When I was with the Treasury Department in 1983, this issue came up. Mr. Pearlman, who was then Deputy Assistant Secretary, testified on the issue; at that time the Treasury Department took the position in opposition to taxation of MLPs as corporations.

The statement in the written testimony says the Treasury Department opposes the proposal which treats limited partnerships with publicly traded partnership interests or instruments evidencing interest in partnership interests as associations for tax purposes. And then later in the statement, Mr. Pearlman said—as was pointed out earlier—"We are not prepared at this time to support the proposals which significantly broaden the two-tier tax system for taxing corporate profits." So, I want to respond in that sense to the suggestion that positions change. Positions change and I think the Treasury Department changes its position, and I am concerned about that.

Let me turn to my remarks. I have a long statement, Mr. Chairman, that is in the record. I want to focus on the basic tax issue involved in MLPs because I am not sure it has received the analysis that I think it should receive.

I think that we ought to start with the conclusion that most tax policy experts agree on, and that is that the double tax system applied to the income of corporations distorts financial decisions to the detriment of us all. It causes corporations to be overleveraged (issue debt), increasing insolvency and bankruptcy, and it discourages distribution of corporate earnings, providing a rationale for management to retain profits, whether or not they can justify the retention by performance. The double tax system is a poor system, and it shouldn't be expanded by applying it to MLPs unless other policy considerations make it necessary.

The two reasons most often given for expanding the double tax system to MLPs is, one, it is necessary to prevent erosion of the corporate tax base or, two, it is necessary to prevent competitive inequality among taxpayers. Both of these points have been made at some length this morning. In my view, neither of these concerns is valid, and I don't think we can justify expansion of the corporate double tax system to MLPs.

Addressing first the fear of erosion of the corporate tax base, the first thing we ought to understand is that the existing corporate tax base is protected from erosion by the repeal of *General Utilities* in 1986 and the taxation of capital gains as ordinary income. The existing corporate tax base is locked into the double tax on corporate income. That is an important point; it is locked in.

The existing base is huge—$2.4 trillion in 1986. It is true that a corporation can liquidate, but if it liquidates it simply accelerates the tax and in present value terms gets no advantage. And that is why we don't see that happening.

I might also add—to digress for just a moment—that with the suggestion that there is a competitive disadvantage with the existing capital the General Motors-DeLorean question really misleads the point. If you repealed the corporate tax for GM on its existing capital, you don't do anything for GM. GM gets no advantage out of that. The GM shareholders would get a windfall, since the value of their stock and the return that that stock will produce, presently assumes a double tax.

If you repeal the corporate tax for GM, you would help its shareholders. So, GM is not helped or hurt in this competitive balance in this MLP fight.

It is the new ventures, the new capital—that is where the discussion should focus. That is why the only legitimate revenue concern is the extent of growth in the corporate tax base. To the extent the growth in the corporate tax base would be financed with retained earnings or with debt, there is no tax disadvantage to the corporation vis-a-vis an MLP. Both corporate retained earnings and debt are single taxed; capital raised through retained earnings is essentially single taxed—a little bit more than single taxed, but much less than double taxed. I won't go into that in detail, but debt and retained earnings are basically single taxed; MLPs are single taxed. So, no competitive disadvantage is there.

To the extent new growth in the corporate sector would otherwise take place with issuance of new equity, then there is an advantage to an MLP vis-a-vis a corporation. The MLP has an advantage because the new equity capital would be double taxed to the corporation while the MLP is not double taxed. So, the revenue concern ought to focus at that level: That is, to the extent that the MLP would replace capital that would otherwise be raised through new equity.

And as the figures in our statement show, that is a relatively small percentage of total equity in the country—8 percent of total corporate capital since the early 1950s has been raised by new equity issues. General Motors and the Fortune 500 Companies simply do not issue any significant amount of new equity for new capital. We go into some length on that in our written statement.

I see my time is up, Mr. Chairman. Let me just conclude by saying that I get a little concerned by the suggestion that MLPs are running around the corporate tax, that they are a private backdoor method of integration not approved by Congress. Partnerships have been in the law for a number of years. They have always been taxed as partnerships. MLPs are clearly partnerships.

The question here today, and the question that this committee has got to consider, is whether you are going to expand the corporate taxation into an area where it has not been previously extended. And I think the point was made earlier that that does limit the number of investors who can participate in single taxed equity investment to higher income individuals, through nonpublicly traded, nonpublicly held partnerships; but it doesn't make the distinction between corporations and partnerships disappear. That exists in the law; you are simply deciding where you are going to draw the line. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you very much, Mr. Chapoton. Mr. Miller?

[The prepared statement of Mr. Chapoton follows:]

STATEMENT OF
JOHN E. CHAPOTON
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
July 21, 1987

My name is John E. Chapoton. I am a partner in the Washington office of the law firm of Vinson & Elkins. I appear today representing Merrill Lynch & Co., Goldman, Sachs & Co., and ENSERCH Corporation. I am accompanied by J. Gregory Ballentine, a principal in the Washington office of Peat Marwick Main & Co. 1/

I am going to focus my remarks on the basic tax policy issues presented by so-called Master Limited Partnerships (MLPs). In my view much of the public debate has been misdirected. Taxing MLPs as corporations can only be justified if doing so is necessary

(a) To protect federal revenues from an erosion of the corporate double tax; or

(b) To prevent competitive inequality among taxpayers. 2/

These considerations do not support corporate taxation of MLPs. I conclude that MLPs will not lead to an erosion of the existing corporate tax base and that any diversion of new investment from the corporate sector into MLPs will have little revenue effect. Moreover, taxing MLPs as corporations would harm, not help, the competitive equality of our tax system.

MLPs Are a Financing Option

A Master Limited Partnership is a limited partnership organized under state law. (Usually there are two limited partnerships, one "master" partnership that is owned primarily by the public, and a second-tier partnership that is the operating entity and is owned primarily by the MLP.) Limited partnership interests, usually called "units", may be readily bought and sold in the open market and are typically listed on public exchanges.

Under present tax law, MLPs are treated like other partnerships. The MLP computes its taxable income and files an information return with the IRS. The partnership itself pays no tax; rather, each partner pays tax on that partner's proportionate share of the partnership's taxable income, whether or not the MLP actually distributes any income to the partners. There is no avoidance or deferral of tax by the partners. Because there is no separate tax imposed at the partnership level, we refer to partnership income as being single-taxed.

There is nothing unusual about MLPs -- they look and act like other large partnerships -- except the fact that interests in MLPs can be bought and sold more readily than interests in other partnerships.

MLPs are utilized almost exclusively as a technique for raising new capital from the public. Tax considerations are important -- as they are in any business financing arrangement -- but there is no diabolic tax avoidance involved, as some seem to imply. In many cases, MLPs have been formed from pre-existing partnerships in industries that have traditionally operated in partnership form. In others, they are one of several financing options available to corporations.

The chief financial officer ("CFO") of a corporation has a range of options for raising new capital from the public: issuance of stock (common or preferred), issuance of debt, use of retained earnings, or creation of an MLP. The tax consequences to the corporation vary according to the option selected.

In most cases, the CFO will rule out the use of new corporate stock. Investments financed by new stock issues incur a double tax. Not surprisingly, new stock issues have been a very small and infrequent source of finance for corporations (only 8% of corporate investment from 1950 to 1983 was financed by new stock issues, and over the last 10 years on average only about 24 out of the Fortune 500 corporations have issued new common stock in any given year).

As described below, investments financed by debt, retained earnings, and an MLP are all essentially single-taxed. Thus this tax consideration is irrelevant to the CFO's choice among these three options. This will surprise many of you and thus bears restating -- when, as is very often the case, every alternative being considered for raising new capital is single taxed, the MLP route offers no tax benefit in this regard as compared to the other financing options on the table. In such a case other considerations will determine whether an MLP is utilized.

There are numerous non-tax reasons for using MLPs. Most common is the desire to avoid additional debt, but there are other considerations as well. For example, several energy corporations utilized MLPs to establish the market value of their oil and gas reserves and thus raise the value of their stock, while also raising capital for development of their reserves. The tax benefits offered by an MLP play little, if any, role in such decisions.

There are also non-tax consequences of MLPs that will not be welcome to the managers of the venture. Primary among these will be the practical necessity of paying out a much larger portion of the earnings of the venture than would be necessary if the corporate vehicle had been selected. The unitholders in an MLP will have paid tax on their share of the earnings of the venture, whether or not distributed, and thus can be expected to insist that significant portions of the income on which they have paid tax be distributed to them. The managers will have to be much more clear about their plans for any retained earnings than would be the case in the corporate context.

Presumably influenced by these factors, MLPs tend to trade in the financial markets at values based on their distributed earnings -- that is, their cash flow -- and are generally regarded as not being suitable vehicles for growth where large amounts of earnings must be plowed back into the business.

Another adverse factor is that the pool of potential investors for MLP units is restricted. Pension funds and other tax exempt organizations do not find most MLPs attractive because they would have to report their share of the MLP's income as unrelated business taxable income; mutual funds find that MLP income is not "qualifying income" for purposes of maintaining their regulated investment company status; and foreigners find they must report their share of MLP income as though they were engaged in the MLP's U.S. business.

Thus while discussion of MLPs (particularly in this room) usually focuses on the tax consequences of MLPs and alternative financing options, in most instances the tax treatment of all the options is essentially the same. In such cases, the non-tax consequences of an MLP -- some favorable and some unfavorable -- will dictate whether the MLP is utilized.

With this background, I would like to review the policy issues involved in expanding the corporate double tax to MLPs.

"Real World" Reasons for Disliking the Double Tax

Tax policy specialists traditionally have argued that all income should be taxed, but only once. Our corporate tax system imposes a double tax on the income from some new corporate investment. The preponderance of tax policy experts argue that such a double tax is an extra levy on certain investment and thus tilts the tax system away from savings and toward consumption. Moreover, it is unclear who actually bears the burden of the corporate level tax -- consumers (through higher prices), labor (through lower wages), shareholders (through reduced dividends), or some combination of all three.

While the incidence of the double tax and its effect on savings and investment are controversial and difficult to verify, we can readily see undesirable effects of the double tax on corporate behavior: (i) it contributes to excessive leveraging of corporate assets by causing corporations to issue debt to raise capital when common or preferred stock would otherwise be more prudent; and (ii) it discourages distribution of corporate earnings by imposing a tax on dividends paid, a tax which may easily be postponed by withholding the corporate earnings from their true owners, the shareholders, and using the earnings as the corporate managers see fit.

If we were designing an income tax on a clean slate, surely we would not intentionally bias corporate finance in favor of debt, with the attendant increased risks of bankruptcy. Furthermore, we would not use the tax system to give corporate managers a rationale for controlling and reinvesting corporate earnings without regard to their investment performance by imposing an immediate tax penalty on earnings that they do not retain.

We would instead design a system of taxing corporate earnings that collects the levy fully and immediately, but is as neutral as possible on such important decisions as whether to increase leverage of corporate assets or whether to distribute or retain earnings. Such a tax system would cause the value of corporate stock to be more closely related to the income it produces.

These are real-world problems caused by the double tax on corporate income. They cannot be solved today because the revenue loss from forgiving the double tax on earnings of today's huge corporate equity base is simply too great. 3/ Just as important, to do so would confer a windfall benefit on owners of existing corporate shares who made their investment decisions based upon the double tax burden.

However, the inability to solve these problems with respect to existing corporate equity provides no justification for extending these rules, with their undesirable consequences, to situations to which they do not now apply. Proponents of doing so seem to assume, often without careful analysis, that failure to tax every investment that "quacks like a duck" -- i.e., is similar in appearance to a corporation -- will either erode the corporate tax base unacceptably, or will render the corporate tax unfair by permitting some ventures in effect to elect pass-through taxation while other ventures remain subject to the corporate tax.

Impact of MLPs on the Corporate Tax Base

Alarmists suggest that the continued existence of MLPs will seriously erode the corporate double tax base in short order. 4/ This concern has been greatly overstated.

The first thing to understand when considering the potential impact of MLPs on the corporate tax base is that the exceedingly large existing tax base is protected from such erosion -- it is effectively locked into a double tax.

The repeal of the General Utilities doctrine and the elimination of the preferential treatment of capital gains combine to assure a full double tax on corporate investment by imposing a corporate level tax on all appreciation of existing corporate assets and by taxing shareholder gain as ordinary income. Even if one assumed corporations might decide to liquidate and reorganize as MLPs (using the equity remaining after tax), there is no avoidance of the double tax on the existing corporate base. The liquidation would simply result in an acceleration of the corporate and shareholder taxes, producing an immediate tax that is equivalent in present value terms to the future taxes that would have been collected had the liquidated assets remained in corporate solution.

Because the existing corporate base is not subject to erosion by MLPs, the only potential adverse revenue effect from MLPs is on the growth in revenues from the double tax base, and that effect could arise only with respect to the new capital raised by MLPs that would otherwise be raised by corporations.

However, only a small portion of the new investment made by MLPs could result in any loss of revenues from the corporate double-tax system. Real estate ventures, for example, have traditionally operated as partnerships. If MLPs are taxed as corporations, new real estate ventures undoubtedly will utilize other partnership forms. With respect to the supposed erosion issue, this means that much MLP investment will simply "erode" other forms of single-taxed partnership investment, thereby not having any tax effect.

Even to the extent that MLP investment substitutes for investments made by corporations, there may be little or no loss of double-taxed revenue from such investment over the next 5 years. As mentioned above, many uses of an MLP by existing corporations allow firms to finance investments using outside funds contributed by investors in the MLP, instead of borrowing the funds for the investment. This is simply a substitution of one single-taxed method of finance, MLP equity, for another, debt. No erosion of the double tax results in this case.

Some MLP investments may substitute for corporate retained earnings, which constitute about 80% of all corporate equity investment. But even in this case, there is no near-term revenue erosion from such substitution; indeed, there is a near-term revenue increase. To the extent that MLP investment substitutes for corporate retained earnings, the infusion of outside equity from the MLP investors allows the firm to lower retentions and thereby to raise or maintain dividends that would otherwise have been reduced to fund the investment.

In the near-term, therefore, the substitution of MLP equity for retained earnings raises revenues by increasing dividends and the resulting dividend tax. Conversely, preventing corporations from having access to outside MLP equity funds will induce them to increase retained earnings and, consequently, to restrain further the payment of dividends, leading to a loss of current tax revenues. In the future, the increased retained earnings resulting from taxing MLPs as corporations may lead eventually to higher revenues as the income on the equity investment gives rise to future dividends.

The only near-term source of a revenue loss from MLPs arises to the extent that MLP investment substitutes for investment that would have been financed by new corporate share issues. Investment financed by new corporate share issues gives rise to near-term double-tax revenues when that investment generates income, a portion of which is paid out as dividends and, thus, double taxed. No doubt because of such a double tax burden on new shares, over the period 1950 through 1985 only about 8% of net corporate investment was financed by new share issues. (See Table 2 below.) It is unlikely that much MLP investment actually will substitute for new corporate share issues, but, to the extent that it does, some reduction in double-tax revenues may result. In the short run, however, this reduction may be offset by the additional taxes on the payout of corporate income as dividends when corporations use MLPs as a source of outside equity funds in lieu of using retained earnings.

There obviously will be no hemorrhage of federal revenues. Based on the revenue estimate prepared by the Treasury Department for the June 30 testimony by Assistant Secretary Mentz before the House Ways and Means Select Revenue Measures Subcommittee, even if Congress takes no action with respect to MLPs, the total effect on Federal revenues in 1990 from applying the double tax to MLPs will be a reduction in revenues equal to only five hundredths of 1% (.00053) of total corporate taxes. 5/

Tax Neutrality and Capital Investment

The fundamental tax policy standard by which MLPs should be judged is their impact on the neutrality of the tax system as it affects

U.S. capital markets. To tax MLPs as corporations, thereby pushing the capital raised by MLPs into the double tax regime, would make the tax system less neutral, since most capital investment in the United States bears at most a single tax.

Ideally, a tax system should not render the cost of capital for investments undertaken in one sector or in one form more or less expensive than if undertaken in a different sector or form. The proper focus of tax neutrality is whether one form of investment requires a higher pre-tax return than other investments. The focus of neutrality is not whether investors in corporations, for example, receive lower after-tax returns than investors in single-taxed investments. The after-tax return to the investor is not a question of tax neutrality at all, since, even in the presence of tax differentials, competitive capital markets insure equal after-tax returns to investors.

Tax neutrality is properly analyzed by comparing the effects of taxation on the required pre-tax return of one type or form of investment with that of all other investments. It is not adequate simply to compare the tax treatment of organizations of a similar size or similar business structure. Achieving equal tax treatment of investments undertaken by entities with similar organizational characteristics or similar size merits no greater significance than achieving equal taxation of investments undertaken by entities with markedly different organizational characteristics or markedly different sizes.

U.S. capital markets are highly interrelated and competitive. New investment projects in any sector or industry must compete for funding with all other investments in the U.S. economy. 6/

If most investment in the United States bears the higher cost of capital attributable to the double tax, then tax neutrality may be improved by subjecting single-taxed investments to the double tax. On the other hand, if most capital investment in the United States bears the lower cost of capital attributable to the single tax, tax neutrality clearly would be worsened by subjecting some single-taxed investments to the double tax.

In fact, most capital investment in the United States bears a single tax or less.

An analysis of the extent of double versus single taxation in the United States is set forth in the Appendix attached to this statement. The extent of double taxation will depend on the mix of corporate, non-corporate, and non-business investment, and on the way in which corporate investment is financed.

Non-corporate business investment, which includes investment by MLPs, is single taxed. Non-business investment, which is primarily investment in owner-occupied housing, is tax exempt. Only the 42% of total investment that is corporate investment is potentially subject to double taxation -- and only a portion of that investment actually is double taxed.

Clearly corporate investment that is financed by debt is single taxed. Further, as explained below, corporate investment financed by retained earnings is essentially single taxed also. Only corporate investment financed by new share issues is subject to the full double tax.

On average over the 23-year period 1950 through 1983, corporations have financed only 8% of new investment through new share issues. Thus, overall, the share of U.S. investment made over these years that is double taxed is a mere 3% (i.e., the 42% of total investment represented by corporate investment, times the 8% of corporate investment that is financed by new share issues).

Investment Financed By New Shares Is Double Taxed

Corporate investment financed by the issuance of new shares must earn a pre-tax return higher than the return required for a single-taxed investment (e.g., one financed by debt) in order to pay the shareholder his required after-double-tax rate of return, because corporate investments financed by new share issues are double-taxed.

Example: Assume 50% tax rates on corporations and individuals and a required 4% after-tax return. A $1,000,000 investment financed by new shares must earn $160,000 (16%) pre-corporate tax to provide $40,000 of after-tax dividends to individuals (a 4% return). This 16% required return reflects the double taxation of the investment. Single-taxed investments need only earn $80,000 (8%) to provide $40,000 of after-tax return to individual investors.

The Tax Cost of Investments Financed By Debt and Retained Earnings Are Similar

The tax treatment of debt and retained earnings is similar -- both are effectively single-taxed.

Debt. Debt finance is single-taxed.

Example: Assume 50% corporate and individual tax rates and a 4% required after-tax return. A $1,000,000 debt-financed investment must earn 8% in order to provide a 4% return to individuals.

Retained earnings. The pre-tax rate of return required to be earned on a retained earnings investment in order to provide a shareholder with the requisite 4 percent after-tax rate of return is equivalent to the rate of return that would have to be earned on a debt-financed investment. Thus, from a cost-of-capital perspective, retained earnings investments are the equivalent of single-taxed investments (i.e., debt-financed investments and partnership investments).

Example: $1,000,000 of after-tax income in a corporation can generate $500,000 of dividends after tax for an individual to invest, for example, by loaning the funds back to the corporation. $500,000 loaned to the corporation at an 8% interest rate returns $520,000 after tax to the investor after one year.

If the $1,000,000 is retained and invested by the corporation at 8% -- the required return on single-taxed debt -- the investor will receive after-tax dividends of $520,000 after one year. (The corporation earns $80,000, pays tax of $40,000, and distributes the remaining $40,000 plus the original $1,000,000 to the investor, who is left with $520,000 after tax.)

Accordingly, debt-financed investment and investments financed by retained earnings require the same 8% pre-tax rate of return. 7/

It may seem puzzling that investments financed with retained earnings are effectively single-taxed, since the future income stream on the investment obviously is taxed twice. The crucial point is that, while there will be future dividend taxes when the income from the investment is distributed, such taxes are offset by the personal tax saved by retaining rather than distributing current earnings. That is, if current earnings are not retained, they must be paid out as dividends incurring a current personal tax. Thus, retaining earnings provides a current personal tax saving. The dividend taxes that are saved currently exactly offset, in present value, the future dividend taxes from the investment financed by retained earnings. As the example given above reveals, the only net tax on the investment, therefore, is the corporate tax itself. Accordingly, investments financed by retained earnings are single taxed. 8/

Capital gains taxes and retained earnings

Since the current dividend tax savings cancels out the future dividend taxes on investments financed with retained earnings, the traditional double tax on distributed corporate earnings does not affect the required pre-tax return on retained earnings investments. Capital gains taxes, however, may have a small effect on that required return.

Sales of stock whose value has risen due to retentions of earnings result in a partial double tax on investments financed with retained earnings. For a 28% statutory rate, this partial double tax is only around 2.8% to 7%. 9/

Thus, even including the effect of capital gains taxes, investments financed by retained earnings are essentially single-taxed.

I realize these examples are complex and that they require study and thought, but their lesson is straightforward. An attempt to subject MLPs, or any other category of partnerships, to the corporate double tax because they resemble corporations in certain respects would not be a move toward neutrality in the tax system. It would be a significant step away from neutrality because --

- U.S. capital markets are highly integrated and those seeking funds for new investments (whether or not in the corporate sector) must compete for funding with all other investments in the U.S. economy.

- Whether by design or accident, most capital investment in the United States bears a single tax or less -- single taxation is the norm.

- In the corporate sector alone, only 8% of investment is financed by new share issues and the balance of corporate investment is financed by either debt or retained earnings, both of which are effectively single taxed -- double taxation is the exception.

Thus taxing MLPs as corporations cannot be justified as a step that will improve the fairness or neutrality of the tax system.

The Inevitability of Some Inequity if Double and Single Taxation Exist

In spite of the evidence just presented, some suggest that MLPs add an element of unfairness or inequality to the tax system in the sense that one taxpayer may be taxed more harshly than another similarly situated taxpayer. For example, one proponent of taxing MLPs as corporations has asserted that it is not fair for a corporation such as General Motors to incur a double tax when it issues new shares while an MLP can raise new equity that is single taxed.

It must be understood that, unless this Subcommittee is willing to apply the double tax to all U.S. investment, including sole proprietorships and debt finance, or is willing to eliminate the double tax on all new corporate investments, this concern over inequity can not be eliminated. Wherever the line is drawn between double-taxed and single-taxed investments or entities, someone can come before this Subcommittee and describe taxpayers on the other side of this line and point to an inequity. 10/

It should also be noted that, as a practical matter, currently the line is not drawn between General Motors and a competing MLP. General Motors will clearly finance a new venture by issuing debt or using retained earnings, both of which are effectively single-tax financing options. The MLP has no tax advantage. Even in the unusual case where a large corporation might issue stock to finance some part of a new venture, the stock issuance will, in virtually all cases, represent a small part of the financing and thus the tax inequity, versus the MLP, will be small or non-existent.

If, on the other hand, MLPs were taxed as corporations, the inequity would then be placed between existing, established corporations that are able to finance new ventures with single-taxed capital (debt and retained earnings), and new firms that wish to raise money in the public markets and would have chosen the MLP route, but now are taxed as corporations. Because they are new, such firms will have no retained earnings and limited ability to issue debt. These firms will be required to finance a new venture with a greater use of double-taxed capital raised by issuance of new shares than would a large established corporation beginning a similar venture.

As long as only some investment is double taxed, some inequity is inevitable. The issue before this Subcommittee is whether moving the line to expand double taxation worsens or improves overall tax equity. The evidence of the previous section demonstrates that single taxation is the norm in the United States. The more investment that is taxed at the norm, the greater is competitive tax equity in the United States. Accordingly, expanding the amount of investment that is double taxed worsens competitive equity, it does not improve it.

Footnotes

1/ The economic analysis contained in this statement is based on a paper prepared by Mr. Ballentine which examines the impact on tax neutrality of taxing MLPs as corporations.

2/ I do not in this statement discuss administrative concerns with MLPs; I do not believe such concerns will or should be a determinative factor in deciding the basic question of how these entities should be taxed. To the extent administrative issues exist, they should be considered and dealt with separately.

3/ At the end of 1986, the value of equity interests held by individuals in U.S. corporations was $2.4 trillion.

4/ Expanding corporate classification rules would result automatically in the classification of owners' income from newly classified "corporate" entities as portfolio income for purposes of the passive loss rules of section 469. Reclassifying, as portfolio income, certain sources of passive income against which passive losses might otherwise be deductible will produce an immediate tax revenue increase to the federal government. However, the issue of an entity's income classification for purposes of the passive loss rules is clearly severable from the issue of the entity's organizational classification for tax purposes, and can be decided outside the context of the organizational classification debate. Given the severability of the two issues, it is not appropriate to characterize revenue attributable to the income classification issue as revenue attributable to the double-tax system, nor is it proper to characterize foregoing collection of revenue under the passive loss rules as an "erosion" of the double-tax base.

5/ The Treasury estimates that in 1990 taxing MLPs as corporations will raise $122 million. However, those estimates indicate that $48 million of this amount comes from treating MLP income as portfolio income, which is separate from the classification issue and can be dealt with separately. The total effect of taxing MLPs as corporations on Federal revenues is, therefore, only $74 million which is .053% of the $139.8 billion in projected total corporate revenues for 1990. It should be stressed that the $74 million figure is the entire 1990 revenue effect of not taxing MLPs as corporations; there is no other revenue loss from such a decision.

6/ For example, the rapid expansion and growing sophistication of the secondary mortgage market has closely tied the mortgage debt market to the general business market for borrowed funds.

that applies to debt, however, is presumably about 28%. Thus while both are single taxed, investments financed by retained earnings are taxed at a slighly higher rate.

8/ It should be noted that retained earnings may result in increased value of stock held until death, in which event an income tax-free increase in basis equal to the retention will occur. The result is an effective tax rate of less than the single tax on investments financed by such retained earnings.

9/ The size of the capital gains double tax depends on many factors including the share of stock held by individuals that is sold each year. Treasury data on sales of stock by individuals in 1973, 1977, and 1983 and Federal Reserve data on holdings of stock by households in 1973, 1977, and 1981, adjusted to exclude nonprofit organizations, indicate that less than 10% of all stock is sold each year. Using this figure and the results of previous research by Martin J. Bailey, a reasonable range for the effective capital gains tax rate on retentions is 2.8% to 7%. This range may, however, be too high since if the dividends resulting from the retained earnings are paid out soon after a step up in basis at death, the effective individual tax rate is below this range. Using the 2.8% to 7% range, the combined tax rate on investments financed by retentions is around 36% to 39%, using a 34% corporate rate. This is in contrast to a 53% tax rate on new stock issues using a 34% tax rate and a 28% individual rate. The 1988 tax rate on debt under current law is presumably about 28%.

10/ It should be noted there is no particular logic in selecting publicly-traded partnerships for the double tax. It is true that large publicly-held partnerships have many similarities to publicly-held corporations. But medium-sized partnerships have many similarities to medium-sized corporations, and closely-held partnerships are in many respects the same as closely-held corporations.

APPENDIX

Extent of Double Versus Single Taxation in the United States

Table 1 shows the distribution of net investment in the United States over the period 1950 through 1985 by the three broad categories: corporate investment, non-corporate business investment, and non-business investment.

TABLE 1

U.S. Net Investment Shares	1950-1985 */
Corporate	42%
Non-corporate business	24%
Non-business	34%

To determine the extent of double taxation of U.S. investment, the financing mix used by corporations must be applied to the overall corporate investment share. Table 2 shows the share of corporate investment financed by alternative sources over the period 1950 through 1983.

TABLE 2

The Corporate Financing Mix	1950-1983 **/
Debt	44%
Retained Earnings	48%
New Share Issues	8%

Applying these figures to those in Table 1, the overall distribution of U.S. investment by tax category can be calculated. The single tax category includes non-corporate investment (24%) plus the corporate investment financed by debt (44% of the 42% of total investment that is corporate, which equals 18%). Overall, then, the single-tax category is 42% (18% plus 24%). The partially double taxed category is the share of corporate investment that is financed by retained earnings (48% of 42%). The only double taxed investment is the 8% of corporate investment financed by new share issues. Thus, overall, the double tax share is 8% of 42%, which equals 3%. The distribution of investment by tax category is summarized in Table 3.

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*/ Source: Commerce Department statistics on constant dollar net capital stocks by type of business.

**/ Source: Federal Reserve flow of funds data. Data after 1983 are not used because there was a surge in repurchases in corporate stock during 1984 through 1986. This made the share of investment financed by new stock issues negative. Such data would reinforce the conclusion of this statement, but may only represent a temporary phenomena and, therefore, that data has not been included.

TABLE 3

U.S. Investment by Tax Category

Non-taxed	34%
Single-taxed	42%
Partially double-taxed	20%
Double-taxed	3%

STATEMENT OF BARRY R. MILLER OF ANDREWS & KURTH, HOUSTON, TX

Mr. MILLER. Thank you. My name is Barry Miller. I am a member of the Houston-based law firm of Andrews & Kurth. Senator, I am not here representing any client, but I am here representing my firm, Andrews & Kurth. That doesn't mean to say I have no interest in this issue, however.

Andrews & Kurth has had the opportunity to participate in the formation of approximately one-third of the existing MLPs. Quite frankly, I would like to be given the chance to form more. I am gratified that I have the opportunity to give to this committee the benefit of any experience that being involved in those formations has given me.

There were so many, I think, inaccurate statements in Mr. Mentz's testimony that I frankly ran out of room on my paper when I was listing them; and I obviously won't have an opportunity to address all of them today.

Senator BAUCUS. You can put it in the record if you want.

Mr. MILLER. I will do that, sir.

[The prepared information follows:]

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September 4, 1987

Senator Max Baucus
United States Senate
205 Dirksen Building
Washington, D. C. 20510

Dear Senator:

During the course of the hearings on master limited partnerships ("MLPs") held by your Subcommittee on Taxation and Debt Management, I indicated to you that Mr. Mentz had many inaccurate statements in his oral testimony. You requested that I provide for the record those inaccuracies that I was unable to address in my allotted time. A brief treatment of those inaccuracies follows.

Equity Replacement. Mr. Mentz indicated that MLPs are a substitute for corporate equity. In fact, however, with the exception of those MLPs formed on the liquidation of a corporation (something which Mr. Mentz admitted will not likely reoccur), in our experience (more than thirty MLPs) not one MLP has been formed which displaced corporate equity. Not once has the sponsor of an MLP indicated to us that the issuance of corporate equity was an alternative to be seriously considered instead of using an MLP. Furthermore, Mr. Mentz's statements about debt suggest that the ratio of corporate debt to equity never changes and, yet, debt has increased, as a percentage of corporate net worth, from 95% in 1980 to 117% in 1986, according to the Federal Reserve Board. Without MLPs, that increase would have been greater (albeit only slightly because of the few MLPs in existence).

Use of Debt. Mr. Mentz indicated that MLPs use significant levels of debt. They do not. While corporations utilize, on the average (based on Federal Reserve data) about a 2 to 1 debt to equity ratio, even a 1 to 1 debt to equity ratio for an MLP is rare. Indeed, the average debt is less than 15% of total capital (compared to the corporate average which exceeds 60% of total capital). Debt, because its presence threatens the stability of cash flow on which the market value of MLPs depends, is in fact minimized by MLPs. Moreover, while Mr. Mentz stated that MLPs use convertible debt, I am aware of only one that has done so (and it is a natural resource MLP, at that).

Rapid Trading. Though Mr. Mentz indicated that MLP interests trade so rapidly that MLP sponsors have difficulty allocating income to owners, no evidence exists to support that conclusion. To the contrary, the investment banking community has continually cautioned MLP sponsors that the lack of trading of MLP interests results in little "float" and less liquidity to the large investor than corporate stocks. Also, the use of computers has enabled MLPs to allocate income in compliance with Treasury's own regulations.

Unlimited Liability. Though Mr. Mentz stated his belief that the factor of unlimited liability that applies to the general partner of an MLP should be ignored in the debate over MLP classification because of its insignificance, we have been unsuccessful in convincing more than a very few sponsors to do so. The amount of nonpartnership assets to be exposed to partnership liabilities has been a central issue in every MLP formation (or aborted formation) in which we have been involved.

Material Disadvantages. Though Mr. Mentz professed an inability to identify any material disadvantages arising out of the use of the MLP form, saying that the disadvantages are "virtually negligible," I listed a number of significant disadvantages in my written testimony. Of greatest importance: MLPs do not have access to institutional and foreign capital--a larger source of capital than the retail market on which MLPs must depend. To emphasize this point, a number of proposed MLPs were abandoned, even after the filing of a prospectus with the Securities Exchange Commission, because of this disadvantage.

Compliance. Mr. Mentz indicated MLP compliance is a problem because of audit difficulties and difficulties with tracking of income. The partnership level audit rules have virtually eliminated the first and the nominee reporting rules should soon eliminate the second. Collection difficulties arising out of MLP audits can be erased by adopting an entity collection/payment measure which falls far short of reclassification of the entity.

Revenues. Mr. Mentz indicated that his feeling was that the MLP issue involved several billion dollars. Yet Treasury estimated a significantly lesser amount and other estimates by notable authorities conclude there is a revenue loss over the next five years after taking into account revenues attributable to the application of the passive loss rules.

Fairness to GM. Mr. Mentz stated that MLP tax treatment was unfair to GM. Not long ago, Mr. Mentz's concern was the "GM factor"--that GM would utilize an MLP. In fact, for all the reasons discussed in my written testimony--need for institutional capital, the need or desire to reinvest earnings and so forth--it seems extremely unlikely GM has, or ever had, any interest in an MLP. It is improbable that GM needs a debt substitute such as an MLP.

Advantage Doubling. Mr. Mentz states that the advantage of using an MLP was doubled by the 1986 Act. As stated in footnote 9 of my written testimony, however, that is misleading. An investor's yield of 10% in corporate form would have been 11.08% in partnership form before the 1986 Act while that same investor's return in partnership form will be 12.17% after the 1986 Act. Only the increase in yield has been doubled and that increase of only 1.09 percentage points is hardly a compelling incentive to use the partnership form in the real world.

Reasons for MLP Formation. Even though Mr. Mentz says that avoidance of corporate taxes is the driving force to form an MLP, not once has corporate taxes been cited by an MLP sponsor as a significant factor in formation of any MLP (other than the liquidation MLP). As with any security, however, its tax treatment in the hands of an investor plays a role in the selection of the nature of the security. Thus, the treatment of an interest in a REIT, RIC, debenture or MLP is relevant in the selection process. Of utmost significance is the simple fact that virtually every MLP sponsor would have used a debt instrument in lieu of an MLP interest had the MLP form been unavailable.

Number of MLPs. Mr. Mentz states that there are 126 MLPs in existence or "in formation". We and the investment banking community estimate there are about 100 MLPs in existence. We do not count MLPs in formation because, based on actual professional experience, the formation of a number of MLPs has been abandoned for many of the reasons stated in my written testimony. Notably, we have experienced the abandonment of MLPs even after initial filings were made with the Securities Exchange Commission.

New Ventures. Mr. Mentz's statement that the start-up MLP may well predominate in the future is unfounded. We know of no MLP engaged in an active business which is a "start-up." In fact, only three MLPs engage in an active business that was not earlier operated in corporate form (other than those MLPs formed to consolidate already existing partnerships). In the real world, the needs of a "start-up" business will preclude the use of the MLP form. For example, a start-up business obviously cannot generate the cash flow necessary to use the MLP form which dictates significant cash flow to investors.

Responsible Tax Lawyer. Despite Mr. Mentz's statement that no responsible tax lawyer would advise the use of other than an MLP for any "start-up" business, all the tax lawyers I know and who have any MLP experience agree with me that it would be irresponsible to recommend the use of an MLP in many instances and in all cases of a "start-up" operating business accessing the public equity market for the first time. Any tax lawyer doing so would likely soon find himself without the client to whom that advice was given--as soon as that client found that even the retail market on which MLPs rely would likely shun interests in that business for many of the reasons stated in my written testimony.

Use of Partnership Form. Mr. Mentz stated that many businesses that have traditionally used the corporate form are switching to the MLP form and cited a number of examples. Of the examples cited, nearly all have in our experience historically relied heavily on the partnership form. That has certainly been the case with sports franchises, cable television, gas pipelines, motion pictures and health care.

Finally, in the course of my oral testimony I offered for the record an analysis of acquisition and drop-down MLP debt which supports the statement made above that MLPs use relatively little debt. That analysis is attached.

Very truly yours,

Barry R. Miller

Barry R. Miller

117/caw
Enclosure

REVISED SELECTED MLP INFORMATION

Name of Partnership	FMV Equity (1)	Debt and Other Long-term Obligations (2)		Current Liabilities (3)	Total Capital
		Total	% of Total Capital		
Dropdown MLPs:					
Allstar Inns, L.P.	$ 135,853,205	$ 137,352,000	50%	$ 2,467,000	$ 275,672,205
Commonwealth Mortgage of America, L.P.	560,606,055	336,924,000	37%	17,053,000	914,583,055
Diamond Shamrock Offshore Partners	814,046,712	-0-	-0-	2,500,000	816,546,712
Dorchester Hugoton, Ltd.	19,758,560	-0-	-0-	70,000	19,828,560
Emerald Homes L.P.	48,100,000	45,949,000	46%	6,371,000	100,420,000
ENSERCH Exploration Partners, Ltd.	1,500,000,000	-0-	-0-	103,375,000	1,603,375,000
Entex Energy Development, Ltd.	138,750,000	9,000	-0-	2,000,000	140,759,000
Falcon Cable Systems Company	108,363,278	20,615,000	15%	4,926,000	133,904,278
FFP Partners, L.P.	41,341,836	-0-	-0-	5,317,000	46,658,836
Freeport-McMoRan Energy Partners	1,000,000,000	28,068,000	02%	131,733,000	1,159,801,000
Freeport-McMoRan Resource Partners, L.P.	1,100,000,000	9,903,000	01%	32,916,000	1,142,819,000
Interstate General Company L.P.	90,000,000	16,866,000	15%	4,516,000	111,382,000
IP Timberlands, Ltd.	3,035,000,000	20,406,000	01%	-0-	3,055,406,000
Lear Petroleum Partners, L.P.	207,666,000	60,000,000	20%	31,902,000	299,568,000
Motel 6, L.P.	606,503,073	538,656,000	45%	60,698,000	1,205,857,073
Perkins Family Restaurants, L.P.	123,171,454	19,967,000	13%	11,285,000	154,423,454
Permian Partners, L.P.	257,764,000	90,000,000	15%	242,465,000	590,229,000
Petrolane Partners, L.P.	430,645,743	252,074,000	34%	57,053,000	739,772,743
Rayonier Timberlands, L.P.	375,757,575	6,122,000	02%	-0-	381,879,575
Reich & Tang, L.P.	139,500,000	-0-	-0-	1,664,000	141,164,000
Sante Fe Energy Partners, L.P.	467,171,717	5,200,000	01%	2,500,000	474,871,717
Sun Distributors L.P.	155,562,197	117,392,000	42%	5,336,000	278,290,197
Sun Energy Partners, L.P.	7,051,851,851	2,135,000,000	22%	567,000,000	9,753,851,851
Transco Exploration Partners, Ltd.	1,165,130,256	147,258,000	11%	74,007,000	1,386,395,256
UDC-Universal Development L.P.	163,604,430	46,540,307	20%	25,144,323	235,289,060
Union Exploration Partners, Ltd.	4,522,058,823	300,100,000	06%	101,800,000	4,923,958,823
Winchell's Donut Houses, L.P.	142,524,360	14,343,000	08%	13,264,000	170,131,360

REVISED SELECTED MLP INFORMATION (continued)

Name of Partnership	FMV Equity (1)	Debt and Other Long-term Obligations (2) Total	% of Total Capital	Current Liabilities (3)	Total Capital
Acquisition MLPs:					
Airlease Ltd.	$ 88,902,778	$ -0-	-0-	$ -0-	$ 88,902,778
Angell Care Master L.P.	52,371,200	57,907,625	52%	-0-	110,278,875
Buckeye Partners, L.P.	224,257,000	302,378,000	56%	17,252,000	543,887,000
Burger King Investors Master L.P.	76,831,425	-0-	-0-	-0-	76,831,425
Cal Fed Income Partners L.P.	102,117,000	45,345,000	30%	-0-	147,462,000
Cedar Fair, L.P.	198,400,000	90,139,000	30%	8,895,000	297,434,000
EQK Green Acres, L.P.	103,081,002	44,000,000	29%	-0-	147,081,002
Equitable Real Estate Shopping Centers L.P.	99,511,000	40,850,000	29%	-0-	140,361,000
Forum Retirement Partners, L.P.	85,302,858	54,631,000	38%	628,000	140,561,858
Galaxy Cablevision L.P.	40,176,767	842,567	02%	-0-	41,019,336
Jones Intercable Investors, L.P.	45,202,978	587,000	01%	375,000	46,164,978
La Quinta Motor Inns Limited Partnership	73,537,500	71,870,000	49%	-0-	145,407,500
Maritrans Partners, L.P.	111,111,500	124,779,000	48%	19,487,000	255,377,500
Mauna Loa Macadamia Partners, L.P.	50,643,939	-0-	-0-	-0-	50,643,939
Red Lion Inns Limited Partnership	91,390,000	105,870,000	52%	4,724,000	201,984,000
Shopco Laurel Centre L.P.	43,339,000	22,500,000	34%	-0-	65,839,000
U.S. Realty Partners	28,258,750	16,639,000	37%	-0-	44,897,750
Valero Natural Gas Partners, L.P.	392,259,070	550,000,000	50%	159,645,000	1,101,904,070
Vista Organization Partnership, L.P.	58,420,965	-0-	-0-	-0-	58,420,965

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(1) This amount excludes underwriters' discount.

(2) To the extent separately stated in pro forma computations, deferred account balances have been excluded from this amount and the current portion of any long-term debt and capital lease obligations have been included in this amount.

(3) This amount includes trade payables, accrued liabilities, and similar obligations.

(4) An affiliate of Motel 6, L.P. issued approximately 200 million of debt exchangeable at the option of the holder into units of Motel 6, L.P. held by the affiliate. The proceeds of such offering then were used by such affiliate to acquire units directly from Motel 6, L.P.

Mr. MILLER. I would like to address a few of them, however. To begin with, as these live—and in some cases, fire-breathing—businessmen have well established much better than I, in the real world MLPs are replacing debt. In the real world, corporations are utilizing MLPs to pay down or avoid the incurrence of additional corporate debt.

The significance of that point is multifold. First, MLPs are not being utilized to avoid the payment of corporate level taxes. They are being utilized to raise capital, to monetize assets, and in some cases to provide liquidity to investors.

Second, and perhaps more important, because MLPs substitute for corporate debt, there cannot be a revenue impact associated with their use. To the extent that MLP equity displaces corporate debt, both are subject to a one-tier tax regime; and no tax revenue can be lost.

I would like to bring a little perspective to some of the things that has been said today. In 1986, corporate equity was reduced by $80 billion; corporate debt went up by $136 billion. Since 1982, MLP equity has been raised in the magnitude of approximately $6 billion. During that same time period, corporations raised as equity $193 billion; but in debt, public debt alone, corporations raised $651 billion.

Senator BAUCUS. Would you read those figures again for us, please?

Mr. MILLER. Yes; $6 billion in MLP equity; $651 billion in corporate debt; and $193 billion in corporate equity.

Senator BAUCUS. And that is for what period?

Mr. MILLER. That is since 1982.

Senator BAUCUS. The total since 1982?

Mr. MILLER. Since 1982, yes.

Senator BAUCUS. Thank you.

Mr. MILLER. That tells me that the growth of MLPs, as has been suggested today, is vastly overstated. I think there are significant operational and legal disadvantages that accrue to the partnership form that will prevent them from expanding with the hemorrhaging effect that Secretary Mentz has suggested.

There will be, if MLPs are treated as corporations, a revenue gain to the Treasury. That revenue gain, though, is all associated with the application of the passive loss rules and not with the classification of the entity rule. The fact that MLPs are debt substitutes also indicates to me that, if MLPs are allowed to continue, they will continue to be used by corporations to reduce their reliance on debt and all of the economic risks associated with debt that were described by the earlier panel.

Something that I simply cannot pass along is my feeling that MLPs do not resemble corporations, but let me take a stab at it. There are some similarities. MLPs, like some corporations—although not many—are publicly traded. MLPs, like some corporations—in some cases—are involved in active businesses; but that is really where the similarities end and the dissimilarities begin.

You have heard about some of the practical and legal differences already. Let me mention four very significant operational differences between corporations and MLPs.

First, unlike corporations, MLPs distribute substantially all their net cash flow. They are a yield-driven security.

Second, MLPs, unlike corporations, limit themselves to single lines of business. You do not see MLPs reinvesting cash flow in additional businesses.

Third, unlike corporations, MLPs do not rely upon debt nearly as heavily as corporations do. There have been suggestions that MLPs are in fact utilizing heavy debt; I would submit for the record an analysis of all acquisition and drop-down MLPs which show that the debt level ranges from two percent to 56 percent of capital, which is significantly lower than corporations.

Finally, MLPs, unlike corporations, simply do not have access to institutional or foreign capital. That alone is the single biggest impediment to the growth of MLPs.

Frankly, because of the economic inefficiencies associated with the corporate tax regime, it makes little sense to me to extend that regime to MLPs. That is the only entity today that seems to be making any in-road, albeit a rather small one, into the rather significantly spiraling use of corporate debt and all of the economic policy evils that are attendant with that.

Thank you, Senator.

Senator BAUCUS. Thank you very much.

Senator HEINZ. Mr. Chairman, I want to apologize to our witnesses for being unable to be here to hear their testimony, but I will be looking with interest at the record and their statements.

Senator BAUCUS. Thank you very much. Mr. Cohen?

[The prepared statement of Mr. Miller follows:]

STATEMENT OF BARRY R. MILLER BEFORE THE SENATE COMMITTEE ON FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT HEARINGS ON MASTER LIMITED PARTNERSHIPS

July 21, 1987

My name is Barry R. Miller. I practice tax law as a member of the Houston-based law firm of Andrews & Kurth. I appear before the Subcommittee as a member of Andrews & Kurth, and not on behalf of any client. Andrews & Kurth has been involved as counsel for the issuer or the investment bankers in the formation of approximately one-third of the master limited partnerships ("MLPs") formed to date.

Since the stated purpose of these hearings is "to examine the impact, if any, of the use of master limited partnerships on the corporate income tax base," I want to emphasize at the outset four conclusions I will support in this testimony:

1. MLPs are being used predominantly to pay down, or substitute for the use of, corporate debt.

2. There is little or no risk that the theoretical tax advantages of MLPs will lead to a reliance on the partnership form rather than the corporate form in the public capital market with the result of a significant impact on the public corporate tax base.

3. Because MLP equity has been used by corporations to reduce or avoid corporate debt, the tax treatment of MLPs does not result in a revenue loss to the federal government.

4. The taxation of MLPs as corporations would be the extension of an economically unsound tax regime to an entity that displaces corporate debt and not corporate equity.[1]

MLP CONCERNS

Representatives of the Treasury Department and other advocates of classifying MLPs as corporations generally voice three primary concerns: (1) the use of MLPs will result in the disincorporation of American business causing a substantial tax revenue loss; (2) MLPs so closely resemble publicly-traded corporations that fairness dictates they be taxed as corporations; and (3) MLPs impose significant administrative problems.

REVENUE LOSS

Disincorporation

There are two types of disincorporation. The more obvious is the conversion to MLP form of an existing corporate business through a liquidation. A less obvious form of disincorporation is the failure to incorporate a business that would have been incorporated, absent the availability of the MLP form.

Existing Corporations. The movement of assets from existing corporations into partnerships can occur in several ways ranging from the liquidation of a corporation into an MLP

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[1] Two of these conclusions were formulated in testimony of Barksdale Hortenstine, also a member of the firm of Andrews & Kurth, before the House of Representatives Committee on Ways and Means Subcommittee on Select Revenue Measures Hearings on MLPs held June 30, 1987 ("House Hearings"). Much of this testimony is a restatement of his testimony in those hearings.

("Liquidation MLP") to the mere contribution of assets of a corporation ("Sponsor") to an MLP, with the Sponsor surviving ("Dropdown MLP"). Only the total or partial liquidation (actual or through dividends or redemptions) of a corporation, however, would entail a possible erosion of the corporate tax base.[2]

It must be emphasized that, as a result of the repeal of *General Utilities*, the tax cost of forming a Liquidation MLP has been significantly increased. Generally, a corporation doing so will be taxed upon liquidation as if it sold its assets for fair market value and the shareholders will then recognize capital gain. The same tax cost is incurred in a partial liquidation except that the income to the shareholders may be ordinary in nature. The two-tier tax which results in both cases is likely to be so substantial as to deter any complete liquidation and most partial liquidations into partnership form.[3]

Similarly, an MLP which has been formed to acquire corporate assets ("Acquisition MLP") will accelerate tax revenues--revenues resulting from the sale of the Sponsor's assets. Furthermore, use of an Acquisition MLP will result in greater tax revenues than would have resulted from a purchase of the same assets by a corporation. Inasmuch as the value placed by an MLP on assets will often be greater than the value a corporation would place on those assets, a seller to an MLP recognizes an increased amount of gain on the sale.[4] Additionally, any corporate purchaser would likely be highly leveraged in order to maximize tax efficiencies.[5] The debt would likely be held by tax-exempt institutions or institutions with low effective rates since historically corporate debt has been held predominately by those entities. In contrast, for reasons which will be detailed later, substantially all MLP interests are owned by individuals. Accordingly, at least one level of tax will be paid on the income servicing the MLP's equity. Moreover, the proceeds from the sale will either be distributed to shareholders or will remain in corporate solution to be reinvested. Either will generate additional revenues in the form of a shareholder tax or in the form of corporate taxes on income from the reinvestment. Certainly, no loss in tax revenues can result.

The Dropdown MLP formed by a Sponsor's contribution of assets to a partnership, merely followed by a sale of an interest to the public by the MLP, involves no movement of assets out of corporate solution. The Sponsor has the same asset value after formation of the MLP as it did before. The Sponsor's interest in the assets conveyed has merely been converted to an interest in the MLP. The income attributable to the assets contributed to the MLP and taxable to the sponsor will be no less than the income taxable to the Sponsor had the MLP not been formed. Therefore, no revenue loss can result.

Finally, since interests in an MLP reflect asset values more clearly than corporate stock, the sale of MLP interests in the trading market likely accelerates tax revenues by triggering the taxation of asset appreciation before the sale of assets.[6]

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[2] Effectively, the same disincorporation effect results when a Sponsor distributes to its shareholders some or all of its Dropdown MLP interests (or proceeds from the sale of those interests) as a partial liquidation.

[3] Importantly, the tax revenues accelerated as a result of a fully taxable liquidation will be recouped through basis utilization (via depreciation or amortization) only over a substantial period of years, if at all. Also, any liquidation of a corporation engaged in an ongoing business will involve nondepreciable assets such as goodwill, particularly under the residual allocation method required by the Tax Reform Act of 1986 ("1986 Act"). Furthermore, the depreciable lives of most assets were increased under the 1986 Act such that the present value of a stream of depreciation has been significantly reduced.

[4] As will be discussed, MLPs are yield-driven vehicles. As a result, values created by MLPs are based on cash flows and not earnings. Where substantial cash flows are present, it is inevitable that an MLP can, and will, place a value on the assets generating that cash flow which will be higher than the value placed on those same assets by a corporation which will value those assets on an earnings basis. The mere fact that an Acquisition MLP is used confirms that it created a greater value for the seller.

[5] MLPs use substantially less debt than do corporations. While it is commonplace for a corporation to have a 4 to 1 debt-equity ratio, an MLP debt-equity ratio approaching 1 to 1 is rare. For example a corporate vehicle used in a leveraged buyout often is capitalized with 90% to 95% debt while those few Acquisition MLPs formed to date have debt not exceeding the 50-60% range. See footnote 25, *infra*.

[6] The more accurate valuation results in substantial part from the fact that the pass-through regime forces MLP management to operate in a more efficient and economic manner.

Though it could be asserted that new MLP equity substitutes for what would otherwise be new corporate equity and that the new corporate equity would generate additional revenues subject to the corporate sector's two-tier tax, the facts simply do not support that assertion. In our experience, no new MLP equity has been found to be a substitute for corporate equity. Use of the MLP form, use of corporate debt or use of retained earnings are generally the only alternatives considered. Corporate equity is simply never seriously considered because of its costs.

Future Corporations. While the conversion of existing corporations to MLPs is now generally acknowledged to be no real threat, concern is still being expressed that future enterprises seeking access to the public marketplace will opt for the MLP form with the result of long term disincorporation--more accurately: a failure to incorporate. That concern, however, is only real if the MLP provides tax and operating benefits that exceed benefits provided by the corporate form. It is only then that the balance in the entity selection process would be lost and the corporate form would become rare, resulting in a tax revenue loss.[7] Notably, this concern would only extend to enterprises accessing for the first time the public capital markets, and only those not already operated in corporate form.

It is clear that there is at least a theoretical tax incentive to operate in partnership form. That incentive was not introduced by the Tax Reform Act of 1986 (the "Act"), however. A fully distributed dollar is affected only marginally by the 1986 Act rates since prior to the 1986 Act the maximum rates applicable to a corporate shareholder and a partner were 73% and 50%, respectively, a difference of 23%, and after full phase in of the 1986 Act the maximum rates will be 52.48% and 28%, a difference of 24.48%.[8] Thus, a widening of only 1.48 percentage points results. Though the impact on a fully reinvested dollar is more significant--a widening of 17.68 percentage points [9]--the argument that this alone will have an impact on taxpayer behavior ignores the reality that few publicly traded corporations pay taxes at maximum rates.[10] Moreover, corporations generally distribute only a small percentage of net cash flow, while partnerships, especially MLPs, distribute most, if not all, of their net cash flow. Since the actual differentials based on effective rates may not be significantly changed by the 1986 Act, it follows that the rate structure cannot realistically be considered a compelling influence to use the partnership form in the public capital markets.

Adding to the observation that the incentive to disincorporate under the new rate structure is largely *overstated*, the disincentives to operating a publicly owned business in partnership form are largely *understated*. The most significant reason not to utilize the partnership form, particularly when interests are publicly traded, is that partnerships are at a substantial competitive disadvantage to corporations in accessing equity capital provided by institutions (both taxable and tax-exempt) and foreign investors.

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[7] One who is strongly committed to an integrated system would argue that such revenues would be replaced by revenues resulting from the more economically efficient application of capital which would occur in an integrated system.

[8] Pre 1986 Act: Corporate dollar: $1 x 46% = 46¢; 54¢ x 50% = 27¢; 46¢ + 27¢ = 73¢.
Partnership dollar: $1 x 50% = 50¢.
Differential: 73¢ - 50¢ = 23¢.

Post 1986 Act: Corporate dollar: $1 x 34% = 34¢; 66¢ x 28% = 18.48¢; 34¢ + 18.48¢ = 52.48¢
Partnership dollar: $1 x 28% = 28¢;
Differential: 52.48¢ - 28¢ = 24.48¢.
Widening: 24.28¢ - 23¢ = 1.48¢

[9] Pre 1986 Act: Corporate dollar: $1 x 46% = 46¢; 54¢ x 20% = 10.8¢; 46¢ + 10.8¢ = 56.8¢.
Partnership dollar: $1 x 50% = 50¢.
Differential: 56.8¢ - 50¢ = 6.8¢.

Post 1986 Act: Corporate dollar: $1 x 34% = 34¢; 66¢ x 28% = 18.48¢; 34¢ + 18.48¢ = 52.48¢
Partnership dollar: $1 x 28% = 28¢.
Differential: 24.48¢;
Widening: 24.48¢ - 6.8¢ = 17.68¢

Some theorists have somewhat unobjectively stated that the 1986 Act doubled an investor's incentive to operate in partnership form. That is, simply, overstating the case. Using *their* numbers, an investor's yield of 10% in corporate form would have been 11.08% in partnership form before the 1986 Act while that same investor's return in partnership form will be 12.17% after the 1986 Act. Though the *increase* in yield has been doubled, the yield itself has been increased by only 1.09 percentage points--hardly a compelling incentive to use the partnership form in the real world.

[10] It has been estimated that the effective corporate tax rate of large corporations approaches only 15%.

The principal roadblock to tax-exempt equity capital is the unrelated business income tax.[11] Moreover, thrifts, trusts, savings banks, insurance companies and other state regulated institutions (both taxable and tax-exempt) are prohibited from investing in partnerships by certain state law prohibitions and federally regulated thrifts are likewise prohibited from investing in partnerships.

An additional disincentive to institutional investors is that MLP interests are high yield-oriented instruments. Yet, institutions have historically been attracted primarily to growth businesses and growth is viewed as much less obtainable by a high yield-oriented entity which, as a result of market demands, must distribute significant amounts of cash. In the case of many MLPs, the demand of the marketplace for cash is so great that the MLP is viewed as a self-liquidating enterprise.

Institutions have also shied away from MLPs as a result of the administrative burden (and related reduction in economic returns) associated with multiple state filings of income tax returns (because an MLP often generates income in multiple states), a burden imposed even on tax-exempt institutions. Lastly, institutions are reluctant to invest in MLPs because of the relative illiquidity of the MLP marketplace. The lower volume of trading of MLP interests compared to corporate stock makes it difficult for large block holders (as institutions would be) to move in and out of an MLP without exposure to large, disadvantageous price fluctuations.[12]

Similarly, foreign investment capital is not readily accessible to MLPs. As a partner in a partnership conducting a U.S. trade or business, foreign investors are deemed engaged in that trade or business and, as a result, are subject to filing a U.S. tax return and paying a tax on their distributive share of MLP income. The increased administrative cost alone may reduce the yield to an unacceptably low level. In addition, MLP distributions to these same partners will generally be subject to withholding which will result in a reduction of after-tax yields since taxes are being prepaid by as much as one year.[13]

For these reasons alone, large or successive equity offerings can rarely be accomplished by MLPs in the smaller retail market on which they depend.[14] Limited access to the institutional and foreign capital markets alone has proven to be, and will continue to be, more than adequate disincentive to most to use the MLP.

Furthermore, MLPs are single purpose, narrow enterprises subject to very restrictive reinvestment limitations. They must provide their investors with substantial current yields which simply cannot be maintained unless all reinvested cash flow, within the narrow limits allowed, is reinvested with such a degree of efficiency that the current yield will not be diluted. Corporate managers, on the other hand, are accustomed to making investment decisions on a noncurrent yield basis.[15] Accordingly, most corporate managers are reluctant to use the MLP form which would (i) force them to forego their power to reinvest on behalf of shareholders and (ii) subject them to the disciplines of the MLP marketplace.[16]

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[11] The unrelated business income tax ("UBIT") rules require that an otherwise tax-exempt entity be taxed on its allocable share of most MLP taxable income, just as if such entity were directly engaged in the trade or business conductd by the MLP. Even if the MLP fails to generate net taxable income, the tax-exempt institution may find unappealing the UBIT rules requiring it to file federal income tax returns because its allocable share of gross unrelated business taxable income exceeds $1,000. Either a tax payment or a tax filing obligation appears to be sufficient to preclude any material aggregate tax-exempt participation in MLP interests.

[12] The institutional distaste for MLP interests is best illustrated by the experience of Community Psychiatric Centers, Inc., a corporation whose announced plans to liquidate into an MLP in December, 1986 were abandoned because of the lack of institutional shareholder support. Similarly, experience has shown that institutions typically sell MLP interests received as a corporate distribution immediately after receipt.

[13] The significance of withholding is illustrated by the Eurobond market disruption occasioned by the decision not to extend the Netherland Antilles treaty.

[14] Of 25 MLP offerings of significance by size completed and analyzed, 11 were reduced in size by an aggregate $430.2 million because of the inability of the market to absorb the offering. Seven MLP offerings were increased in size but the aggregate increase was only $186.5 million.

Another constraint on the growth of MLPs is the requirement imposed by current Treasury regulations that a general partner maintain substantial assets (generally in the range of $7 to $10 million, at a minimum) *in addition to its interest in the partnership.* As a result of this requirement, Sponsors are forced to expose to MLP creditors assets that would otherwise likely be shielded from such exposure.

Other legal and practical differences between partnerships and corporations also discourage the use of the partnership form. For example, the uncertainties regarding the applicability of partnership law may prevent the use of the partnership form. Significantly too, MLPs exist in the environment of a yield market -- so much so that many MLPs have distribution support mechanisms which may require a subordination to the public of the Sponsor's share of cash flow or, in some cases, an injection of additional cash by the Sponsor. Where business does not have adequate, predictable cash flow (or a Sponsor willing to "guarantee" the existence of cash flow) to meet the cash yield demands of the marketplace, the MLP is simply not a viable form for the business enterprise.

For these many reasons, it seems clear that a tradeoff of operating advantages and disadvantages of the corporate and partnership forms exists in the public equity market today. In effect, the MLP form is relegated to those few circumstances where the desire to displace debt coincides with those operating and business characteristics required by the retail marketplace -- a relatively small niche of American business.

That this tradeoff provides a fair balance in the entity selection process, and that the MLP niche is small, is evidenced by the fact that, to date, only 92 MLPs have been formed, excluding MLPs formed to consolidate existing partnerships. In dollar numbers, since 1982, approximately $6 billion of equity has been raised, in the aggregate, by MLP offerings (approximately 75 separate issues). During the same five-year period, approximately $193 billion of public corporate equity has been raised through common and preferred stock offerings (over 4,000 separate issues of common stock alone). Of the MLP transactions, only 20 were Liquidation MLPs (all completed prior to the effective date of *General Utilities* repeal) and, of the remaining 72, only 3 were enterprises which were (i) not already operated in corporate form and (ii) accessing the public equity capital market for the first time. Furthermore, notwithstanding the supposed incentives to disincorporate provided by the 1986 Act, an average of only 4 MLPs have been formed each month since enactment while an average of 3 MLPs were formed each month in the 18 months preceding the effective date of enactment.[17] These statistics seem to objectively demonstrate that those government officials, practitioners, and members of the media troubled by disincorporation are simply responding to ill-founded fears or unobjective, or uninformed, analyses. Any threat of disincorporation attributable to MLPs simply pales by comparison to the erosion of the corporate tax base attributable to the spiraling increase in the use of corporate debt.[18]

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[15] Instead, performance of corporate managers is most often measured by reference to such standards as earnings per share, a concept most believe is not a true indication of economic income.

[16] The best evidence of this reluctance is the absence of support from the corporate sector for prior attempts to integrate (in whole or in part) the corporate income tax system.

[17] Any analysis of MLP growth must focus on MLP ownership outside the Sponsor corporation. Since Sponsors typically retain significant portions of the MLP (as much as 97%), growth in MLP asset value cited by uninformed commentators--as opposed to public ownership--is totally misleading as to the growth of MLPs. Moreover, examples of growth cited by the uninformed have included (i) transactions that have not proceeded (such as a sports franshise MLP filed in April, 1987 and a highly leveraged pipeline MLP) because of the very market constraints discussed, and (ii) transactions which, because they were consummated before the repeal of *General Utilities*, will not likely be duplicated.

[18] Since 1980, corporate debt has risen from 95% of corporate equity to 117% of corporate equity according to the Federal Reserve Board.

Revenue Impact

Since MLPs are subject to a single tax regime, a loss of revenue can only result from their use if MLP equity is replacing corporate equity which is subject to a double tax regime. That is simply not the case. Historically, corporations have found that debt and retained earnings are less expensive sources of capital than corporate equity. Not surprisingly, therefore, corporations rely heavily on those sources. In fact, the trend over the last few years is even greater dependence on debt by corporations.[19] Thus, during the same period that corporations raised $192 billion in equity, they also raised over $651 billion in publicly-offered, long term debt (*not including commercial paper, private debt and bank debt*).

To the extent that corporate debt is displaced by MLP equity, not only is no tax revenue lost but also that displacement will result in an *increase* in tax revenues to the extent the corporate debt was held or would have been held by either a tax-exempt institution or a low taxable entity.[20] To the extent that corporate retained earnings as a source of capital are replaced by MLP equity, there should result an *increase* in tax revenues since such earnings would then be available for distribution to shareholders generating taxes at the shareholder level. Thus, a common sense analysis inevitably drives one to the conclusion that MLPs are, at worst, *revenue neutral*, but more likely *revenue positive* in the near term.

Said another way, treatment of MLPs as corporations will likely result in a revenue loss, at least in the short term.[21] Corporate managers would simply return to the traditional sources of capital: debt and retained earnings. Furthermore, an MLP treated as a corporation would act like a corporation--increase its debt load, reduce dividends and look for other ways to shelter its income. Any tax revenues to be collected on the eventual distribution of its retained earnings would be collected well into the future since, absent a dramatic change in the structure of corporate taxation (such as an integrated system), there exists on the horizon no incentive to change old habits of postponing the dividend tax.

CORPORATE RESEMBLANCE

Probably the most used argument for taxing MLPs as corporations is that an MLP so closely resembles large, publicly traded corporations that it must be taxed as a corporation. In other words, to administer the taxing system fairly and to maintain the integrity and neutrality of the corporate tax, similarly situated taxpayers should be taxed in the same manner (that a "level playing field" must exist).

The focus of the neutrality analysis should not be on the relative positions of the corporate and MLP investors. Because capital users are competing for the same capital, it must be assumed that after-tax returns to investors have been equalized by the marketplace in pricing the securities issued in exchange for the capital. The focus should instead be on the relative positions of the entities.

If one entity is, in actual practice, disadvantaged in accessing capital because of the assessment of taxes and that disadvantage is not, in actual practice, at least offset by other factors, neutrality may require common tax treatment of the entities. Some, mistakenly, apparently believe that is so as to MLPs and corporations.

Apparent Weakness of Argument. From an economic policy perspective, the neutrality analysis applied to MLPs appears substantially flawed. The analysis assumes that there is a

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[19] *Id.*

[20] Notably, the debt market is dominated by pension funds, life insurance companies, casualty insurance companies, commercial banks and thrifts, all organizations that pay little or no taxes. On the other hand, MLP interests are owned by individuals who are fully subject to tax.

[21] The conclusion that a revenue loss will likely result from entity reclassification ignores any revenue benefit derived from the automatic conversion of MLP income from passive income to portfolio income that results from the corporate classification of MLPs. For this purpose, it is assumed that any such revenue benefit should be severed and viewed separately from any revenue benefit (or detriment) attributable to entity reclassification.

segmentation of the U.S. capital markets and that there should be a parity between only some of those segments. The analysis further assumes that the two segments being equalized are interchangeable. Thus, the parity sought is between new corporate and new MLP equity. Yet, MLP equity *is not* interchangeable with corporate equity since it does not substitute for corporate equity. Rather it substitutes for corporate debt. Nevertheless, those advocating parity with respect to capital do not suggest parity among debt users.

Different Playing Fields. If principles of neutrality must be applied in reviewing the issue of MLP classification, perhaps the conclusion should be that any real or perceived advantage that an MLP has from a tax perspective is at least "neutralized" by significant legal and operational disadvantages. Particularly relevant to the neutrality analysis is the earlier observation that MLPs are at a very significant competitive disadvantage in accessing institutional and foreign capital.

Tradeability. Assuming principles of neutrality, when properly applied, constitute good policy, it must be questioned whether such policy is well served by effectively imposing a tariff on a feature that is not inherent in the form of entity: tradeability. That result appears inconsistent with the fact that the perceived advantage (lower cost equity capital) that arguably necessitates the imposition of the corporate tax is possessed by the MLP, not the investors who benefit most from tradeability.

ADMINISTRATIVE CONCERNS

Although administrative concerns have in the past been expressed in support of the reclassification of MLPs, there is now general agreement that such concerns do not justify reclassification--that such concerns can be addressed short of reclassification of MLPs as corporations.[22] Prior to the 1986 Act, the most serious compliance issue faced by MLPs was arguably inadequate reporting procedures for street name owners of MLP interests. With the now present nominee reporting rules and soon to be present attendant penalities, any compliance problems with street name owners will be solved (especially once the system to respond to the rules has had time to develop).

Collection of partnership deficiencies is another administrative concern that some believe needs addressing. It is argued, for example, that small audit adjustments may not warrant the effort of collecting a deficiency from thousands of partners. A partnership level system of collection from an MLP may therefore be appropriate.

ECONOMIC AND OTHER POLICY CONSIDERATIONS

Economic Policy Under the Corporate Tax System. There is apparently a consensus among many Treasury officials, economists and policymakers that the corporate tax system has little value. It does produce tax revenues, however. Economically, the two-tier tax discriminates against those activities traditionally conducted in corporate form. It theoretically increases the cost of equity capital to the corporation and, as a result, may reduce levels of output in the corporate sector. In addition, avoidance of the two-tier tax often drives corporate management to use cash flows in an economically inefficient manner in order to maximize tax efficiencies. The result is often a dedication of cash flow to tax sheltering, a reinvestment policy emphasizing earnings, which often have little to do with economic yield, and other activities which diminish the capacity and desirability of dividends. Thus, by providing management with such a significant reinvestment incentive, the corporate tax is promoting a misallocation of economic resourses.

Perhaps more importantly, the imposition of a two-tier tax promotes the funding of corporate activities with debt capital rather than equity capital, by allowing the deduction of interest but not dividends. At the corporate level, the income generated from the use of debt capital is offset, for the most part, by interest deductions. Thus, the most tax efficient source of capital in the corporate sector is the debt market. At the creditor level, interest income is subject to taxation only if the creditor is a taxable person and then only at the creditor's effective rate. As said earlier, it has historically been the case that corporate debt is held predominantly by non-taxable persons or those who have low effective rates. Accordingly, corporations are encouraged by our tax system to use the one source of capital serviced by corporate income that goes largely untaxed. That this results in a substantial revenue loss to the government cannot be refuted.[23]

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[22] Mr. Mentz, in his testimony in the House Hearings, stated: "The administrative difficulties of a pass-through model for MLPs . . . could be addressed by measures short of taxing MLPs as corporations."

The debt incentive inherent in the corporate tax regime also distorts business behavior by providing tax benefits (such as interest deductions and depreciation) that will often make assets more valuable in the hands of an acquiring corporation than in the hands of the present corporate owner. This induces corporations to transfer their assets to other corporations, with economic considerations being secondary. Many attribute the recent surge of leveraged buy-outs and corporate debt recapitalizations almost exclusively to this debt incentive.

Any expansion of the corporate tax regime (such as to MLPs) can only accelerate the current trend of corporate management to rely on debt as the primary source of capital with the associated loss of revenue and economically distorted business behavior. Moreover, corporate overleveraging greatly undermines the economic stability of the corporate sector, those regions dependent on debt heavy industries and, perhaps, the economy as a whole.[24]

Economic Policy Under the Pass-Through Tax System. Compared to the economic policy evils attendant to the corporate tax, the partnership regime is most attractive. Since MLPs are free of the influence of debt incentives, they have provided corporate managers an efficient means for raising equity capital as either a *replacement* for existing debt or a *substitute* for future debt. As capital raised through an MLP is generally in the form of equity, the opportunity for long term economic stability in both the business sector and the economy as a whole is enhanced.[25] In fact, most MLPs formed to date have been used by corporations to repay or avoid corporate debt. It is estimated that 95% of the cash proceeds raised through MLP equity offerings was used by either the corporation forming the MLP or the MLP itself to retire, or avoid the incurrence of, corporate debt.

Significantly, MLP interests are structured as yield-oriented investments. Without the excuse to avoid dividends provided by the two-tier tax, managers of MLPs are subject to significant restraints imposed by the marketplace on their ability to reinvest cash flows. These restraints dictate that an MLP only reinvest when the reinvestment is consistent with the limited purpose for which it was originally formed. This reinvestment can only be justified to MLP interest owners if nondilutive from a cash flow perspective. The demand for cash distributions leads to a responsiveness to owners unlike that of corporate management. In short, because MLPs are not afforded the tax bias for reinvestment under their current system of taxation, capital flows to those areas producing maximum economic (not necessarily tax) gain.

Small Investors: A Matter of Fairness. MLPs also provide small investors an opportunity to invest in a limited scope entity free of conglomeration and free of the volatility of a stock market dominated by institutions. The MLP has therefore tapped an unused source of investment capital and extended to the nonwealthy benefits of direct investment previously available only to the wealthy. It is not surprising, therefore, that the most frequent purchase of MLP interests is around 200 partnership units--from $2,000 to $4,000.

In short, as a matter of economic policy as well as fundamental fairness it seems imprudent to extend corporate taxation to MLPs.

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[23] For example, an LBO will utilize that amount of debt, and no more, necessary to eliminate corporate level taxes and that debt will likely be held by tax-exempts.

[24] The regional impact of excess leverage is well illustrated by the slow pace with which the economy of the oil producing states is recovering despite the partial recovery of oil prices. Quite simply, leverage levels predicated on crude prices of at least $30 per barrel cannot in the normal course be serviced with crude prices hovering at $18 per barrel.

[25] As evidence that MLPs use relatively little debt, an analysis of all operating Dropdown and Acquisition MLPs shows debt levels (excluding trade payables and accrued liabilities) ranging from 2% to 56% of capital with most in the 30% to 45% range. Chances are that the 70% debt MLP mentioned by Mr. Mentz in the House Hearings was not consummated because the debt level was too high for the market in which MLP interests are sold.

REVENUE: PASSIVE INCOME

Obviously, it is my belief that sound tax and economic policy dictate that MLPs be treated like what they are: partnerships. To the extent the classification issue is, in reality, a revenue issue, it appears clear that it would be appropriate for the Subcommittee to consider legislation characterizing income from MLPs as other than passive income for purposes of the passive loss rules.[26] Such treatment, as a matter of tax policy, is predicated on the same theory underlying the treatment of portfolio income: a taxpayer whose income is from investments should not be given opportunities to shelter that income when the same opportunities are not available to the wage earner. Failure to reclassify MLP income, therefore, may result in disparate treatment of fundamentally similarly situated taxpayers.

It must be emphasized that the reclassification of MLPs as corporations will generate tax revenues from the resultant treatment of MLP distributions as dividends (which are portfolio income not subject to tax sheltering for purposes of the passive loss rules). The same revenue result can be achieved by merely changing the classification of MLP *income*. Thus, any revenue analysis done on entity classification must be viewed in light of the amount of revenue derived not from entity classification but by virtue of the passive loss rules.

CONCLUSION

It is clear that the 1986 Act increases the tax burden on corporations. It is extremely doubtful that this will result in any significant movement to the use of MLPs. Though the relative disadvantages of the partnership form may have been dulled some by the 1986 Act, the biggest single disadvantage remains: inability to access institutional and foreign equity capital. Because the balance has not shifted to the partnership form, MLPs will simply not displace corporations as the predominate force in the public capital markets. MLPs will continue to be used only by those businesses that can, and are willing to, submit themselves to the limitations of the retail capital market.

MLPs will also be used in the future as in the past to displace corporate debt. Thus, no revenue loss can, or I submit will, result.

Finally, both sound tax and economic policy dictate continuing treatment of MLPs as partnerships. It would seem, at best, imprudent to discourage the use of one of the few entities that actually slows the spiraling corporate debt trend, with whatever small economic benefits that may obtain, and, at the same time, avoids many of those corporate operating philosophies which are viewed by so many as an anathema to sound economic policy.

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[26] This "heads Treasury wins--tails taxpayer loses" approach does not trouble the MLP community. Pre-tax yields and business fundamentals (not tax benefits) drive the investment decision in the case of MLPs.

STATEMENT OF RICHARD G. COHEN OF WINTHROP, STIMSON, PUTNAM & ROBERTS, NEW YORK, NY

Mr. COHEN. Mr. Chairman, thank you for asking me to speak today. My name is Richard Cohen. I am an attorney specializing in Federal income tax matters. I am in the private practice of law in New York City and have been for the last 23 years. From 1976 to 1984, I was the reporter for the American Law Institute's study of the partnership tax provisions. The American Law Institute is an organization of approximately 3,000 lawyers and judges which, over the years, has produced what I consider distinguished studies, model criminal codes, in the course of that time; and is now studying corporate governments.

During the course of that time, it produced studies that led to the corporate partnership provisions of the 1954 Code. It has since then produced a major study on corporate taxation. It is engaged in one on taxation of international transactions and also a study on partnership tax provisions.

The work is done on a collegial basis. It is reviewed first by a small group of academics and practitioners, then by a larger group of approximatey 100 tax lawyers from around the country. We were fortunate to have Mr. Chapoton's presence in that group and gain his counsel, although not necessarily his agreement with our proposal on master limited partnerships. The work is then reviewed by the counsel of the Institute and its membership and is then issued in the form of a book, which is available to Congress, to other tax professionals that are interested in these studies.

In its study of partnership taxation, the Institute considers which entities should be classified for tax purposes as partnerships. We concluded that entities formed under a version of the Uniform Partnership Act should generally be taxed as partnerships; but we concluded then—in what now seems like much simpler times—that there should be a special exception for partnerships with publicly traded interests.

They seem to us to occupy the same economic niche as corporations, and we thought they ought to be taxed as corporations. At that time, there were integration studies. During my professional career, there have always been integration studies.

The two-level corporate tax has been a source of concern for many years, but the fact of the matter is that it has been maintained. If you were to abandon it, you would have to ask yourselves where the $120 million now coming from the corporate income tax would be raised.

I think each time Congress has considered integration explicitly, I think it has faced the complexities of integration, the difficulties of administration, the difficulties of enforcement and collection, and a general feeling that the corporate income tax does, in fact, work.

Now, against that background, it seems to me it is hard to justify the creation of an essentially new entity, the master limited partnership; and I will say why I consider it a new entity, if I may, Mr. Chairman, in a moment.

But the creation of such an entity has a need for financing. In 1980, when we were in the midst of studying it, we found one company—Apache Petroleum—that was then listed on the New York

Stock Exchange that was the only MLP in existence at the time that was publicly traded that we knew of; and there was some question as to whether we should cover the subject at all. I think we were foresighted.

I think that the number 126 shows that there are not just a few of them, but there is an enormous expansion. If I looked at the exponential curve that is set out in the Treasury study that shows three in 1981, five in 1982, six in 1983, going on to 28 in 1985, 38 in 1986, and then 40 in the first half of 1987, and thought of that as representing $6 billion, I would be greatly concerned about where that exponential curve is leading, just how much tax revenue will be sacrificed to the MLP concept in the coming years.

I think they have been said to be a substitute for a much greater amount of corporate debt. I think, Mr. Chairman, your committee is going to be called upon to consider just what interest on corporate debt should be deductible. I mean, that is an area that professionals are studying now and that the American Law Institute in particular is looking at right now. I think there is a real issue as to whether you can afford to have a corporation with 100-to-1 debt-equity ratio avoid all income tax because of its interest cost.

When you come to that point, I think it will be unfortunate if the people who testify in favor of allowing the interest deduction for every level of corporate debt—junk bonds and what-have-you—are able to say, well, if you don't permit this, we can always go the MLP route. That is another way of raising funds for corporate-type of activities and not have a corporate level tax.

I see my time is up. I would just like to make a closing statement that I think that with MLPs, Mr. Chairman, you may well be at a crossroads. If you permit them, Secretary Mentz testified in favor of grandfather provisions. The American Law Institute concluded there should be grandfather provisions.

The question is just how great the revenue invested in those grandfather provisions are going to be when you have a universe with 600 MLPs and maybe $100 billion raised in capital in that way.

Thank you very much for giving me the opportunity to appear, Mr. Chairman.

Senator BAUCUS. Thank you, Mr. Cohen.

[The prepared statement of Mr. Cohen follows:]

STATEMENT OF

RICHARD G. COHEN

My name is Richard Cohen. Thank you for asking me to speak today.

I am an attorney specializing in federal income tax matters, and practising law in New York City. From 1976 to 1984 I was the Reporter for the American Law Institute's study of the partnership tax provisions and was recently chairman of the Tax Section of the New York State Bar Association. My comments today, however, are in a personal capacity and should not be taken as representing the views of either the American Law Institute or the New York State Bar Association.

The American Law Institute recently completed an eight-year study of partnership taxation. As part of that study, the Institute considered which entities should be classified for tax purposes as partnerships. The ALI concluded that entities formed under a version of the Uniform Partnership Acts should be taxed as partnerships but the proposal specifically excepted partnerships with publicly-traded interests. We were concerned that in such partnerships the interests were much more like stock than like traditional partnership interests, particularly in being highly liquid and fungible.

When the ALI considered the issue, there was only one partnership listed on a major stock exchange. Now, of course, additional master limited partnerships ("MLPs") are added to stock exchange listings almost on a weekly basis.

Tax MLPs as Corporations

Manufacturing and other MLPs which are publicly traded and not engaged in traditional partnership activities should be taxed as associations.

MLPs erode the corporate tax base. We have now seen that MLPs can be used to conduct almost any business. Moreover, there is no longer a trade-off between a lower current tax at the entity level and the cost of distributing funds to pay the taxes of the owners. Because tax rates for corporations are generally higher than those for individuals, it is now cheaper for a business to make a distribution to its owners to pay their taxes on its income than for the business to pay the corporate tax.

The inroads of MLPs into businesses traditionally conducted by tax-paying corporations have been modest so far. However, we are witnessing an acceleration of a trend of forming new businesses as partnerships and later bringing them to the capital markets in partnership form. In contrast, existing corporations face an extremely heavy cost in converting to partnership form, particularly in light of General Utilities repeal. It makes no sense for the tax system to favor new entrants to the capital markets over older enterprises in this way.

Other Methods of Circumventing Corporate Tax

Operating as an MLP is, of course, only one way of bypassing the corporate income tax. The corporate tax is also being bypassed by so-called "junk bonds" -- bonds issued with returns that are similar to some extent to equity returns but on which payments by the issuer are deductible. "Market rate" preferred stock -- stock issued with returns that are far less than market interest rates but which are designed to be equivalent on an after tax basis to corporate bonds -- also erodes the corporate tax tax base. Such preferred stock is designed to be sold to corporations that can take advantage of the dividend received deduction. The "dividend" on this preferred stock is usually reset at regular intervals to take account of changes in market interest rates.

Other Considerations

There are other tax problems inherent in classifying MLPs as partnerships, although they may not in themselves warrant taxing MLPs as corporations. The major classes of technical problems raised by MLPs other than erosion of the corporate tax base are:

1. Uniform income and loss to all holders of the partner interests in a given class

Section 704(c) requires differentation between partnership interests that were originally obtained by contribution of appreciated or depreciated property and those obtained in return for a cash contribution to the partnerships. Even with a §754 election in effect, this difference often carries over to purchasers of partnership interests. Indeed, the §754 adjustment itself can produce differences in treatment, such as the fact that depreciation on the §754 adjustment is often subject to different rules than depreciation on the underlying property.

MLPs typically try to make offsetting allocations to give each holder the same share of income and loss despite §§704 and 754. These allocations are, at a minimum, highly questionable. The pressure for such allocations is largely limited to publicly traded partnerships, however.

2. Audit and collection of taxes

An MLP is subject to audit as a single entity, like most other partnerships. However, taxes due as a result of any audit adjustment have to be collected from the partners. When interests in an MLP are publicly traded on a stock exchange, the number of persons who held interests during a part of the year in question may be huge and many of them may owe only a tiny amount. Collection may not, therefore, be practical.

Large partnerships could be required to pay a "withholding" tax (at the maximum individual tax rate) on their income and allocate the payment as a creditable tax payment to their partners. If the income of the partnership is adjusted for a year, the partnership would have to pay any additional "withholding" tax corresponding to the adjustment. A similar technique is already in place for payment of the windfall profits tax.

3. Difficulty of Classification Under Present Regulations

A third technical problem raised by almost all MLPs is that under the Section 7701 classification regulations, they are usually close to the borderline between corporations and partnerships. The regulations classify an entity as a partnership if it lacks two or more of four specified "corporate characteristics". Almost automatically, most MLPs have two of the corporate characteristics (free transferability of interests and centralized management). Hence any MLP generally makes only the minimum possible showing to fit within the regulations.

However, the MLP problem should not be addressed at this level. The present regulations (which were drafted to prevent professional associations from being classified as corporations) do not provide a sensible dividing line. They are not directed at economic reality but at technical details. This is one of the reasons that the ALI proposed that UPA and ULPA partnerships not publicly traded should invariably qualify for taxation as partnerships.

Which partnerships should be taxed as associations

The main reason for taxing some partnerships as corporations is to prevent erosion of the corporate tax base. That is why MLPs, which are basically economic substitutes for corporations, should be taxed as such.

However, the characterization should not be based solely on size. For example, many professional partnerships have more than 35 partners but are apropriately taxed as partnerships.

Partnerships in which interests are publicly-traded on a securities exchange should generally be taxed as corporations. If partnership interests are initially sold on the understanding that someone (such as a brokerage house) will make a market in the interests, the partnership should probably be taxed as a corporation. It does not, however, seem appropriate to tax as a corporation any entity that would otherwise be properly taxed as a partnership if the benefical ownership is not traded on some more-or-less formal market.

Moreover, there are many partnerships with publicly-traded interests that are not appropriate candidates for the corporate tax. Some activities have long been carried on in significant part by pass-through entities and therefore, when carried on by a publicly-traded partnership, do not present a threat to the corporate tax base. Among these are real estate holding companies and other entities which own interests in (but don't actually carry on the extraction of) natural resources. Similarly, investment companies that hold passive interests in other enterprises have been taxed as pass-through entities, similar to partnerships, and do not represent a threat to the corporate tax base. The principal examples are investment funds and issuers of collateralized mortgage obligations.

This list is not meant to be exhaustive and I'm sure there are other activities which should be added. However, as a general rule, any publicly traded entity which itself conducts significant active industrial, extraction, manufacturing or selling activities should not quality for exemption and should be subject to the cororate tax.

Senator **Baucus**. Mr. Chapoton, you were once Assistant Secretary of the Treasury. You know as well as we do how important it is to prevent unreasonable hemorrhaging of the Federal revenue and to get the budget deficit reduced.

You say, in effect, you disagree with Secretary Mentz's projections of revenue loss because MLPs are a substitute for debt and not for equity; and you had some other explanations as well, namely the corporate structure is protected because of the repeal of General Utilities and other reasons.

If, in fact, though, Secretary Mentz's projections turn out to be accurate, when do you think there is cause for, if not alarm, at least concern that perhaps this committee and the Treasury Department should figure out some way to protect that unnecessary hemorrhaging? At what point do you think that, whether Secretary Mentz's projections are accurate or inaccurate, due to a revenue loss the Treasury Department and this committee should revisit the issue?

Mr. **Chapoton**. Mr. Chairman, first of all, I think that the revenue is probably the issue. My problem with the Treasury Department is not with the numbers. I mean, we have done our own revenue estimate. Peat Marwick and some people who are very reputable have done estimates which I would like to submit for the record, which show a different result.

[The prepared information follows:]

8246X

THE REVENUE EFFECT OF TAXING MLPs AS CORPORATIONS

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I. OVERVIEW

Master Limited Partnerships (MLPs) are, in essence, a financing option for obtaining investment funds. Use of an MLP allows a business to sell units in the MLP in order to raise funds for investment in the activity to be conducted by the MLP. The income on such investments is taxed only once at the level of the individual investor. In contrast, if funds were raised by issuing new corporate shares, double taxation would occur since the income on corporate equity financed investment is double taxed. Consequently, taxing MLPs as corporations will affect revenues if both of the following two factors are present (i) the investment that would be funded by use of an MLP under current law would instead be undertaken and funded by a corporation--including potentially the same business that would have been an MLP--and (ii) the income from such corporate investment would be double taxed. Conversely, no revenue effect will arise from taxing MLPs as corporations when either (i) that activity that would have been funded by use of an MLP under current law would be undertaken and funded by entities that continue to be subject to a single tax, or (ii) a shift to corporate funding of the activity involves a source of corporate finance (e.g. borrowing) that is single taxed.

The second condition necessary for there to be a revenue effect is important because a large share of corporate investment is single taxed, not double taxed. The clearest example is debt financed corporate investment. Since interest payments are deductible at the corporate level, the only tax on the interest component of corporate investment income is the individual tax paid by the lenders to corporations. Over the period 1950-1983, about 44% of net corporate investment was financed by debt.

The largest single source of funds for corporate investment (48%) is retained earnings. Retained earnings are an equity source of investment funds and, therefore, the income from such investment is double taxed. However, if funds are not retained, they must be paid out as dividends thereby giving rise to current individual taxes on the dividends. That is, current income in a corporation is subject to a double tax, whether or not it is paid out currently. Retaining the income postpones the double tax, but does not reduce it in present value. Paying out the income causes the double tax to be paid currently.

The testimony of John E. Chapoton before the House Subcommittee on Select Revenue Measures of the Committee on Ways and Means (July 1, 1987) explains that the cost of capital for investment financed by retained earnings is essentially the same as the single taxed cost of capital for debt. The use of retained earnings to finance an investment implies that the future income on that investment will be double taxed, but it also implies that current double taxes are avoided. The net tax burden on the investment financed by retained earnings is only the corporate tax itself.

As explained more fully below, the revenue effect of a decision to finance investment by retaining more earnings is first a reduction in revenue, as current individual dividend taxes are reduced, then an increase in future revenues as future dividend taxes are increased.

Corporate investment financed by new share issues results in a clear, unambiguous double tax. By purchasing new shares, individuals commit new funds to corporations without any current tax saving. The income on the investment is double taxed. Not surprisingly, since new share financed investment bears a high tax burden, only a small portion of corporate investment (8%) is financed by new shares. Clearly, revenues are increased when more investment is financed by new corporate share issues.

II. THE REVENUE ESTIMATING MODEL

As discussed above, the revenue effect of taxing MLPs as corporations depends on how corporate investment that would have been funded by an MLP would be financed by the corporation in the absence of MLPs. Before specifiying the detail of the revenue estimating model, two other issues must be addressed.

First, due to the repeal of the General Utilities doctrine and the full taxation of nominal capital gains, only future investment and how it is financed is relevant for the revenue estimate. That is, under current law a full double tax must be paid if existing corporate assets leave corporate solution. In general, this full double tax will at least offset in present value the tax savings from converting the existing corporate equity from double taxed investment to single taxed investment.

As a result, the revenue effect from taxing MLPs as corportions is based on the amount of new investment that will be converted into corporate form, instead of being undertaken by an MLP. This brings up the second issue to be dealt with before explaining the estimating model. If MLPs are taxed as corporations, not all investment that would have been undertaken by MLPs will be undertaken by corporations. Other partnership forms can be close substitutes for an MLP. These other partnerships can be quite large and their shares of interest may even be transferable. As a result, if MLPs are taxed as corporations, many ventures that would have been undertaken by an MLP might be undertaken by a partnership not in MLP form. Clearly no revenue effect arises from shifting some investment from being undertaken by an MLP to being undertaken by some other type of partnership.

Based on the foregoing, the model begins with the projection of the path of a new investment that would have been undertaken by MLPs. The model assumes that, with no change in the tax laws, MLP investment will grow rapidly. Specifically MLP investment is projected to rise 40% in 1988, 35% in 1989, 30% in 1990, 25% in 1991, and 20% in 1992. As just mentioned, if MLPs are taxed as corporations, a portion of this investment will shift to other partnership forms. There is no reason, however, to expect that portion to grow over time; therefore the investment that will be in corporate form due to the law change will grow over the period 1989-1992 at the same rate as overall MLP investment grows over that time period. This is the investment stream that is the basis for the revenue estimate.

The key issue for the revenue estimate is how this additional corporate investment will be financed. The model uses three different sectors, oil and gas, real estate, and "other." It is assumed that the additional corporate investment in each sector is financed using the same debt/equity ratio as is found in the respective sectors. Based on I.R.S. statistics, the debt/equity ratio for the oil and gas sector is assumed to be .99 (i.e. there is about $1 of debt for each $1 of equity), in the real estate sector it is assumed to be 2.81 and in the "other" sector it is 1.02. MLP real estate investment is considerably larger than that of the other two sectors. As a result, the overall estimate is that well over half of the additional corporate investment will be debt financed.

Since debt financed investment is single taxed at the individual level, there is no revenue effect due to the shift to corporate debt financed investment from MLP investment. A revenue effect must come from the MLP investment that shifts to corporate equity financed investment. A simple example will help to explain how the model deals with this important case.

Suppose that $100 of new investment that would have been MLP investment instead becomes corporate equity financed investment. There are two sources of corporate equity finance, retained earnings and new stock issues. Historically, new stock issues have accounted for only about 20% of equity finance and retained earnings accounted for 80%. Using those figures, the corporate sector will issue $20 of a new stock and will retain an additional $80 of current earnings. The immediate effect of the increased retentions is a loss of revenues because the $80 of additional retentions lowers dividends by $80 thereby lowering taxes on dividends by $22.40 (at a 28% tax rate).

Working in the opposite direction to this loss of revenues is the additional taxes due to the double taxation of the income from the entire $100 equity investment. Assuming a 10% pre-tax return, the $100 of equity investment generates $10 of pre-tax income and $3.40 of corporate taxes. If 50% of after-corporate-tax income is paid out as dividends, the $6.60 of corporate income after taxes gives rise to $3.30 of dividends, which, when taxed at a 28% rate, results in $.92 in individual dividend taxes. Further, the $3.30 of retained earnings raises the value of the corporation's stock by that amount. If 10% of stock is sold each year, this results in $.09 in capital gains taxes (10% of $3.30 taxed at 28%).

The total tax on the income from this investment in the first year is $4.41; $3.40 of corporate taxes, $.92 in dividend taxes, and $.09 in capital gains taxes. If the investment had been undertaken by an MLP, the $10 of investment income would have been taxed once at a 28% rate. Thus, it would generate $2.80 in taxes. The extra tax on the income from the investment due to taxing MLPs as corporations is, therefore, $1.61 ($4.41 less $2.80).

In the first year, then, the overall effect on revenues in this simple example is a net loss of $20.79. Revenues fall $22.40 due to the reduced dividends and rise $1.61 due to the double taxation of the income from the investment, as well as the fact that corporate income is taxed at a slightly higher rate (34% in the example) than partnership income (28% in the example).

If $100 of additional investment occurs in the second year and it too is divided into $20 funded by new share issues and $80 from additional retentions, then the revenue loss will decline. This is because the revenue loss due to lower dividends still is $22.40, but the revenue gain from the double taxation grows to about $3.30 since income on both the first year investment and the second year investment is double taxed. If $100 of additional investment occurs every year, the revenue loss will eventually become a revenue gain.

The above example was purposefully simplified to highlight the importance of the two sources of equity finance, retained earnings and new share issues. In the actual model used, only 20% of additional corporate equity investment comes from retained earnings as opposed to 80%, which is the historical ratio. The remaining 80% is assumed to come from new share issues. These ratios were chosen deliberately to be conservative. The higher is the retained earnings share, the larger will be the revenue loss in early years. In addition, since new share issues are the most heavily taxed source of finance, it should be expected that corporations will largely substitute use of an MLP for new share issues. Given this factor, the assumption that only 20% of the additional equity finance comes from retentions is a reasonable, conservative estimate.

The actual model also assumes that the before tax yield in the three sectors fluctuates with the prime interest rate. The prime rate series used comes from the Data Resources Institute long range forecast in the winter of 1986-87. Using information published in the March 1987 Stanger Report, it was calculated that in the oil and gas sector the pre-tax yield is slightly below the prime rate, in the real estate sector it is about 25% above the prime rate, and in the "other" sector it is equal to the prime rate. Also based on information from the March 1987 Stanger Report, in the oil and gas sector it is assumed that 80% of financial income is tax sheltered, 50% in the real estate sector is sheltered, and 30% in the "other" sector.

These parameters dealing with pre-tax rates of return and the fraction of income sheltered determine the income that would have been taxed at the partnership level, but instead will be taxed at the corporate level. To determine the revenue from double taxation, it is also necessary to know the dividend payout ratio in each sector. Based on IRS Statistics of Income data, the payout ratio in the oil and gas sector was set at 55%, in the real estate sector it was set at 50% and in the "other" sector it was set at 37%. Finally, data indicate that about 35% of corporate securities are held by tax exempt entities or otherwise did not give rise to reported taxable dividend income.

III. SPECIFIC RESULTS

Based on the data described above, the model gives the following estimates for the change in fiscal year receipts from taxing MLPs as corporations assuming (i) that existing MLPs are grandfathered and (ii) that, by a separate provision, the income of MLPs is treated as portfolio income while the losses are passive.

The estimate is broken down into two components--the revenue gain from additional double taxation and the revenue loss from increased retentions.

Revenue Effect of Taxing
MLPs as Corporations
(Existing MLPs Grandfathered
and MLP Income Treated as Portfolio Income)
($ in millions)

	Fiscal Year Receipts				
	1988	1989	1990	1991	1992
Double Taxation Effect	4	16	31	53	84
Retained Earnings Effect	-23	-53	-61	-67	-70
Net Effect	-19	-37	-30	-14	14

For purposes of comparison, the Treasury estimates are presented below. The Treasury estimates come from the testimony of Assistant Secretary J. Roger Mentz before the Senate Finance Committee on July 21, 1987, table 3. Those estimates do not show directly the same proposal estimated above. They show the effect of taxing MLPs as corporations assuming that MLP income would be treated as passive income. This proposal combines the effect of classifying MLPs as corporations with the effect of preventing income in MLPs from being available to offset passive losses. Howevre, the Treasury table also shows separately the effect of treating MLP income as portfolio income. The residual between the two estimates corresponds to an estimate of the proposal considered in this report, i.e., a proposal that is limited to classifying MLPs as corporations. The Treasury estimates presented here exclude existing entities from the proposed change.

Treasury Estimates of the Revenue Effect
of Imposing a Double Tax on MLPs
(Existing MLPs Grandfathered)

($ millions)
Fiscal Year Receipts

	1988	1989	1990	1991	1992
Tax MLPs as as Corporations Assuming MLP Income is Passive	24	69	122	188	264
Less: Treat MLP Income as Portfolio Income	9	27	48	73	103
Equals: Classify MLPs as Corporations Assuming MLP Income is Portfolio Income	15	42	74	113	161

The Treasury figures do not divide their revenue estimate into the increased revenues from double taxation and the reduced revenues from reduced retained earnings. Further, Assistant Secretary Mentz's testimony does not indicate what assumption the Treasury used with respect to the way any additional corporate investment is financed.

Clearly our estimates suggest a small revenue loss in the early years from taxing MLPs as corporations. The Treasury estimates indicate a small revenue increase. However, the comparison of the two estimates clearly indicates that, under both estimates, the revenue effect of taxing MLPs as corporations is very small.

Mr. Chapoton. Let's assume the Treasury Department's results are accurate. There simply is no hemorrhage going on. I am puzzled here, as I was on the House side, by the difference in the figures and the statement, for example, because it was stated to you that there was a hemorrhaging going on here. But when you look at the revenue estimates, and let's just work from Treasury's revenue estimates, the first thing you have to do is subtract from the line showing the revenue loss from the tax on MLPs as corporations the impact of the passive loss rule. You can treat distributions from MLPs as portfolio income and thereby strengthen the passive loss rules, which Mr. Mentz is suggesting, but that doesn't have anything to do with strengthening the corporate tax. It strengthens the passive loss rule.

Senator Baucus. Right.

Mr. Chapoton. So, you need to deduct from—on his Table 3—the figures in line 3 from the figures in line 1; and you see that the revenue loss estimate that Treasury is predicting for the next three years is $121 million; and in the next five years—and I have already done the math—it is $400 million. Just take 1990, for example, on Treasury's figures, the lost revenue from doing nothing would represent 5 one hundredths of one percent; that is .00053 of the total revenue from the corporate tax. I would hardly call that a hemorrhage.

I do think that, if the committee thinks there is going to be a hemorrhage, you have got to worry about this; and I think the Treasury ought to worry about it, but it simply hasn't been shown.

Senator Baucus. At what point should we start worrying?

Mr. Chapoton. Do you want a dollar figure or do you want a percentage? I don't know, Mr. Chairman. I don't think it will occur; so, I hate to speculate, but I think that we are going to have the revenue concern for the rest of this century. And I think you have to worry about it. When it reaches the $2 to $3 billion range, you certainly have to worry about it.

Senator Baucus. You mentioned that the corporate tax base is protected because of the General Utilities repeal and other reasons. And then, you suggested that it is not unfair to GM because of the benefits of conversion to MLP at GM would go to the shareholders and not to the company itself; but isn't that unfair to the shareholders?

Mr. Chapoton. No, I don't think it is unfair to the shareholders. The shareholders are in the marketplace; they are getting a reasonable return on their investment. It is true that their investment is valued after taking into account the two levels of taxes; but the shareholders of General Motors versus the unitholders of a DeLorean MLP are both getting a reasonable after-tax return on their investment.

If you repeal the corporate tax to GM, those shareholders get a windfall. In other words, where equity is held in corporations, the value of that equity reflects the double tax on corporations.

Senator Baucus. Mr. Miller, why are MLPs limited to a single line? Why wouldn't MLPs—if this committee does nothing about the tax consequences—get into various lines of business?

Mr. Miller. As a theoretical matter, they can, Senator; as a practical matter, they cannot. As I said earlier, MLPs are yield-driven vehicles. The marketplace today demands that an MLP throws off a significant cash yield. To the extent that an MLP, therefore, reinvested cash flow in another line of business, it cannot assure to the investor that yield.

Furthermore, most MLPs—although I suspect perhaps there are some exceptions—are limited to single lines of business by their organizational documents. I submit to you there are probably no corporations that are so limited. So, it is a marketing and a legal limitation at this point.

Senator BAUCUS. Couldn't the organizational articles provide that certain income be invested in a new line or the same line? Wouldn't the partnership holders still have some return or some cash returned to them, less perhaps than they would otherwise have? Is it illegal for the organizing articles to so provide?

Mr. MILLER. No, it is not. It is clearly not. What it is, though, is a market-driven response. That is, again, the market demands that the yield be so high that most MLPs have found that the only way that they can maintain their value is to only reinvest their cash flow on a very limited basis in the same business.

One of the principal advantages that an MLP has is that it is free of the conglomeration effect that so many corporations are not free of. One can invest in a Freeport McMoRan or any of the others that have been mentioned today, and the investor can be assured that that company will not begin investing in some business which is unrelated to the basic activity of that enterprise.

Senator BAUCUS. You also mentioned that MLPs do not use debt. Isn't that because generally MLP tax consequences are more attractive?

Mr. MILLER. No. Really, the debt in many instances intrudes upon the ability of the MLP to provide yield. Look at it in terms of how much in dollar amount you want standing in front of you as a holder of an MLP interest—equity interest—for that yield? To the extent that there are significant amounts of debt and there is a modest downturn in the business in which that MLP is engaged, that modest downturn will come 100 percent out of the pocket of the MLP equity owner and not the debt holder. So, MLPs again are market driven by the yield requirement not to have significant amounts of debt. Now, to suggest that they don't use any debt is incorrect; and if you read me as saying that, no. I want to clarify that; they do use debt. But they simply do not use debt in any fashion comparable to the historic use of debt by corporations.

Senator BAUCUS. Under what circumstances would you advise a newly forming organization to not organize as an MLP but rather as a corporation?

Mr. MILLER. Are you addressing that to me, Mr. Chairman?

Senator BAUCUS. Yes, go ahead.

Mr. MILLER. I would say any time an enterprise is seeking to access the public marketplace for capital and it is necessary to provide a yield which is not then being generated by that enterprise. Said another way——

Senator BAUCUS. What would an example be? What would the business of the company be?

Mr. MILLER. It is really not so much an industry as it is a maturity question. The more mature the business, the more likely that it has adequate cash flow to meet the yield requirements. The suggestion that a new enterprise will be formed and will immediately go into an MLP form is, frankly, absurd because the MLP market today requires that there be a yield. An immature business cannot provide that yield.

Said another way, growth businesses by and large cannot operate in the MLP form. The principal advantage that a corporation has over an MLP today is that a corporation can access institutional and foreign capital. MLPs simply cannot do that.

Let me say it another way. An enterprise wishing to obtain significant public capital must, by its very nature, go into the corporate capital market, not the MLP capital market, because MLP interests are bought by the retail investor who demands that yield and not by the institutions that do not want the unrelated business's taxable income that is associated with it.

So, as a practical matter, all new enterprises will come to a crossroad and say to themselves: I have a choice of going into the partnership form and precluding access to the largest single segment of the capital marketplace today or not. If you choose to go into the MLP form, you will preclude yourself from the single largest component of equity capital today.

Senator BAUCUS. Mr. Cohen, do you have any examples of organizations which you would think should be organized into corporate as opposed to partnership form? Do you agree with Mr. Miller, or do you have any other comments on that?

Mr. COHEN. I agree with Mr. Miller that you encounter different problems when you form an MLP. You are addressing yourself to a different part of the market; and I suppose, at the present time, it has no appeal for foreign investors and it may not have appeal for some institutional investors. I think in time vehicles will develop that have the necessary appeal to anybody who wants to get his income free of a corporate tax.

I wonder if I could introduce an example which, as I listened to Mr. Miller, occurred to me? You have a series of rules that addresses regulated investment companies, mutual funds. You can form a mutual fund, and you can do it on a pass-through basis. Congress decided that that was all right.

But they said, in their wisdom, you can only do it if it distributes 90 percent of its income, if it doesn't have more than 10 percent of its assets invested in one entity, and so forth. There is just a whole bunch of detailed rules.

Right now, the Technical Corrections Act of 1987 is worrying about how much short-short income a mutual fund should be permitted to have; how much less than three-month income it should be permitted to have. I don't know what the right answer is for any of those rules, whether the right decisions were made in each case; but the idea that I can tell one of my clients to forget those rules that govern mutual funds; they don't mean anything. Just form an MLP, and you can operate without any restraint at all. If you want to have 15 percent of your assets invested in a single corporation, that is all right. If you want to own 20 percent of a single corporation, that is all right.

So, I see the MLP as really a threat to the integrity of a great many Congressionally determined rules; and I would be interested in Mr. Miller's reaction to that. What do you do?

I understand now there are several mutual funds that have been formed as MLPs; and I assume that they are subject to SEC restrictions, of course, but they are not subject to any of the restrictions that are built into the rules about the basis of their income and the nature of their assets.

Mr. **Miller**. May I respond, Senator?

Senator **Baucus**. Yes, of course.

Mr. **Miller**. The response to that is that no revenue would be generated by forcing MLPs to operate in mutual fund form. If this is, in fact, a revenue issue, what Mr. Cohen unfortunately has failed to mention is that mutual funds—like MLPs—are pass-through entities. So, from a revenue standpoint, this committee should be indifferent whether that enterprise is operated through MLP form or through—as he calls it—a mutual fund.

Senator **Baucus**. From a revenue viewpoint, that might be true, if it is under the jurisdiction of this committee; but if there were reasons for the restrictions, Mr. Cohen mentioned that it applied to mutual funds—that is, a percent is passed through and a percent is invested, et cetera, it is another issue. Mr. Chapoton?

Mr. **Chapoton**. Mr. Chairman, I think we are always troubled by a set of rules that doesn't apply here; but I am afraid that we are in a hopeless morass if we start down that track. I mean, then you would have to say a smaller partnership that cannot comply with the Subchapter S rules ought to be taxed as a corporation; and heaven knows why the REIT rules came to be what they are today. I would defy anyone in this room to explain that. So, I just think to build in that logic, we are really going to be in trouble.

Senator **Baucus**. Secretary Mentz was concerned about compliance. Mr. Miller and Mr. Chapoton, what advice do you have for this committee to make sure we have adequate enforcement?

Mr. **Miller**. In my judgment, there are two issues that must be looked at. One is the question of whether an audit at the entity level gives rise to such awkward collection problems that assessment and collection against the entity ought to be considered.

I think the only other question on the compliance side is the one that arises out of MLP interests being held in street name. There has often been a suggestion that that generates significant noncompliance. There has been enacted in the 1986 Act a provision requiring those who hold units in an MLP for the benefit of another to provide information to the partnership to allow that partnership to generate customized K-1 information and tax data, both to that partner and to the Internal Revenue Service. I submit to you that that will eliminate—when it is in operation—any suggestion that Treasury cannot track into individual 1040s—tax returns—the tax information that is provided by the partnership.

I don't think there is a compliance problem. That street name ownership provision will allow Treasury to determine whether I am right or wrong.

Senator **Baucus**. Thank you. Mr. Chapoton?

Mr. **Chapoton**. I think the compliance problem should be reviewed very closely. I think the partnership audit level and the collection of taxes on the deficiency is probably the biggest single problem. So, I don't want to minimize the fact that there may be compliance problems. I think frankly there is no evidence that there is a significant problem. The 1983 testimony also addressed that point. It wouldn't drive this issue, but it should be reviewed; and I think I would go along with the partnership level collection of taxes on deficiencies.

Senator BAUCUS. Before adjourning, do any of you have any burning comments you want to pass on at this point? Do you have a comment on any outrageous statement that you have heard today? [Laughter.]

Mr. MILLER. How hungry are you, Mr. Chairman? I have a lot that I would like to submit.

Senator BAUCUS. No hungrier than you are. [Laughter.]

Mr. MILLER. I will submit them for the record, but the basic point that I would like to leave today is that the suggestion that MLPs act like corporations is simply absurd when analyzed from a legal point of view or from an operational point of view. I think that it makes no sense to extend to MLPs the tax treatment of corporations. And that conclusion, by the way, has been confirmed by not just Mr. Chapoton and myself, but the AICPA, the American Bar Association, and the New York State Bar Association Section on Taxation. All testified before the House and did not provide testimony here.

Senator BAUCUS. Anyone else?

Mr. CHAPOTON. Mr. Chairman, a thought did just occur to me. If I could submit the Treasury testimony of October 24, 1983 by Deputy Assistant Secretary Pearlman to the record, when the Treasury took the opposite position that it is taking today, that discussion begins on page 51 of that testimony.

I would also say that I do think the revenue concern is the issue. I do not think the Treasury figures or anything that we have seen—and we have really inquired about this—would indicate that revenue is a significant concern.

Senator BAUCUS. Thank you all very much. The subcommittee is adjourned.

[Whereupon, at 12:47 p.m., the hearing was concluded.]

[By direction of the chairman the October 24, 1983 statement of Deputy Assistant Secretary Pearlman, submitted by Mr. Chapoton, and additional communications were made a part of the hearing record:]

TREASURY NEWS
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STATEMENT OF
RONALD A. PEARLMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on a preliminary report, prepared by the Staff of this Committee (the "Staff"), entitled "The Reform and Simplification of the Income Taxation of Corporations." This report sets forth proposals which would make fundamental changes to many of the rules of Subchapter C of the Internal Revenue Code (the "Code") governing the taxation of corporations and their shareholders. Three principal suggestions are advanced: (1) A new scheme for taxing corporations and shareholders participating in corporate mergers, acquisitions or liquidations would be provided; (2) The taxation of distributions by ongoing corporations to their shareholders would be changed significantly; and (3) A new set of rules would be created to determine the extent to which net operating losses and other corporate tax attributes survive corporate acquisitions. The report also addresses other collateral matters including the classification of publicly traded limited partnerships as corporations for tax purposes, and certain issues arising in connection with the taxation of foreign corporations.

The stated goals of the proposals are four fold: (1) To simplify the taxation of corporate transactions; (2) To prevent corporations from obtaining unintended tax benefits; (3) To make the tax law more neutral with respect to the structuring of corporate transactions; and (4) To improve compliance with the tax laws.

I will summarize briefly our position on the respective proposals before discussing each in more detail:

1. Acquisitions. The Treasury Department supports granting the corporate parties to an acquisition an explicit election to treat the transaction as either taxable or tax-free. We also agree with the proposal to require corporate level recognition of gain or loss on the assets acquired whenever the acquisition is effected with a taxable election and those assets take a stepped-up basis in the hands of the acquiring corporation. However, we do not believe that the acquisition should result in double taxation of liquidating gains, and suggest that relief in the form of a shareholder tax credit be explored.

We also support treating the tax consequences of an acquisition at the shareholder level independently of the consequences at the corporate level. Further, we agree that, to the extent a shareholder receives qualifying consideration, the shareholder should be entitled to nonrecognition of gain or loss without regard to the consideration received by, or the tax consequences resulting to, other shareholders.

2. Liquidations. The Treasury Department agrees that, in general, liquidations of nonsubsidiary corporations should be treated analogously to taxable corporate acquisitions. We also believe, however, that serious consideration should be given to allowing an in kind liquidation to be accomplished on a wholly or partially tax-free basis under appropriate circumstances.

3. Distributions. The Treasury Department supports the proposal which provides that a corporation recognizes gain on a dividend distribution of appreciated property to noncorporate shareholders. We oppose, however, eliminating the earnings and profits limitation on dividend income. To the extent inadequacies in the rules presently exist, we prefer identifying and rectifying the specific sources of the problems.

The Treasury Department agrees that the holding period for stock on which dividends would be eligible for the dividends received deduction should be increased to provide a market risk sufficient to offset the arbitrage possibilities presented. When the holding period is not satisfied, we suggest that the arbitrage possibilities be eliminated through an adjustment to the basis of the stock. We oppose, however, the proposed amendment to section 265 to disallow interest deductions on debt *incurred to purchase or carry certain corporate stock.* Rather, we believe that the appropriate solution lies in a reappraisal of the dividends received deduction provisions themselves.

4. Foreign Rules. The Treasury Department believes that the impact of the proposals generally on the taxation of foreign corporations and their shareholders requires further analysis. With respect to the report's specific foreign recommendations, the Treasury Department agrees that the tax avoidance purpose test of section 367(a) should be amended to require an appropriate "toll charge" as a condition for certain tax-free transfers to a foreign corporation. We believe that the report's proposals relating to the timing and extent of "recapture" of untaxed earnings (and certain unrealized gains) of a controlled foreign corporation require further study.

5. Special Limitations on Net Operating Losses and Other Tax Attributes. The Treasury Department generally supports limiting the use of net operating loss carryovers after an acquisition by reference to the income attributable to the pool of capital that generated the loss. We believe, however, that the technical provisions proposed by the Staff to implement this approach might be simplified and improved by adoption of a single rule applicable to all acquisitions.

6. Entity Classification. The Treasury Department opposes the proposal which treats limited partnerships with publicly traded partnership interests (or instruments evidencing interests in partnership interests) as associations for tax purposes.

In general, the Treasury Department strongly supports the overall goals of the proposal, and we commend the Staff's efforts to identify those corporate tax provisions of current law which need to be revised. At the outset, however, we wish to emphasize that the scope of these proposals is enormous. They would make fundamental changes to the rules that govern the most basic, as well as the most intricate, corporate transactions, some of which have been in the law since 1918. The proposals would affect, to some degree, every corporation and every shareholder. Accordingly, we strongly believe that adoption of these proposals should come only after they have been translated into specific statutory provisions and subjected to deliberate and detailed technical and policy analyses by all interested parties. We would be pleased to work with the members of the Committee and the Staff on an ongoing basis to develop such a legislative package.

A special consideration applies, however, with respect to the rules regarding the limitations on net operating loss carryovers, since the provisions enacted in 1976 are presently scheduled to become effective in 1984. Accordingly, more rapid development of that portion of the proposals is required. By the same token, however, enactment of these provisions should not be undertaken without adequate time for detailed study. Therefore, we suggest that the effective date of the 1976 revisions be deferred for a few months so that the Congress is not faced with the choice of enacting incompletely developed proposals or allowing the former, undesired provisions to come into effect.

Additionally, while we support the goals of the proposals, it must be pointed out that certain of the proposals cannot be expected to achieve each of their stated objectives. For example, many of the transactions to which the acquisition proposals will apply are extremely complex and intricate. Any new scheme for taxing those transactions will necessarily mirror that complexity. Thus, we do not believe that those proposals should be viewed as an effort to simplify the tax laws. With appropriate modifications, however, the proposals may be justified on the grounds that they will make the taxation of corporate acquisitions more rational, and will make the tax laws less important with respect to the structuring of those transactions.

Similarly, not all of the transactions affected by these proposals are susceptible of taxpayer abuse. To the extent that specific abuses have been identified which mandate a prompt legislative solution, we would be pleased to assist in that effort. We believe, however, that some of the perceived abuses identified in the report can be addressed in ways that do not require implementation of the Staff's proposals.

It also should be noted that the proposals are not only far-reaching, but several would have significant revenue consequences. I wish to reaffirm that the Administration opposes any legislation at this time which would increase taxes. Accordingly, our support for certain of the proposals is based on our determination that they will prevent taxpayers from claiming unintended tax benefits. Our support for other proposals is based upon our understanding that they would not have any significant revenue impact.

Finally, we wish to call attention to one of the most basic assumptions upon which this report rests. The report assumes that the present system of imposing a corporate level tax on corporate profits and a separate tax on shareholder gains and dividends will continue indefinitely. The strength of many of the proposals lies in their rationalizing and strengthening this two-tier tax to the greatest extent possible. We believe, however, that Congress should not embark upon such a fundamental strengthening of this two-tier tax system without at least giving serious consideration to whether integration of the corporate and shareholder taxes is a more desirable long-term objective.

I will turn now to a discussion of the specific Staff proposals.

The Acquisition Proposals

Description

The acquisition proposals would revise the tax consequences to parties participating in corporate acquisitions. The proposals have three essential elements:

1. The corporate parties may elect to have the transaction treated as either a tax-free or taxable acquisition. If taxable treatment is elected, the acquiring corporation ("Acquiring") inherits none of the tax history of the acquired corporation ("Target"), and Acquiring takes a stepped-up basis for the assets acquired (*i.e.*, the tax basis of the assets at the time of the acquisition reflects the value of the consideration paid by Acquiring). If tax-free treatment is elected, all of Target's historic tax attributes, including asset basis, remain intact.

2. In any transaction in which taxable treatment is elected, Target must recognize all gains and losses which inhere in its assets, with certain limited exceptions described below. This result would reverse present law, which provides that a corporation generally does not recognize gain or loss on the distribution of property to shareholders or on sales of property incident to complete liquidations. If tax-free treatment is elected, Target generally would not recognize any gain or loss as a result of the acquisition.

3. The tax consequences to Target's shareholders is determined independently of the tax treatment elected by the Target corporation. If qualifying consideration -- generally stock of Acquiring -- is received by a Target shareholder, no gain or loss is recognized on the exchange of Target stock, and

existing at the time of the acquisition, as reflected in the proposal, the built-in losses would be relevant for such a purpose whether or not those losses are realized during the year. The determination of the amount of such losses would, of course, be administratively difficult and quite complex.

Finally, the proposal contemplates that the amount of net built-in losses would be limited by regulations to the extent necessary to preclude avoidance of the pool of capital principle. The problems raised by built-in losses are complex and require careful study. A persuasive argument can be made, however, that built-in losses existing at the time that ownership of the corporation changes hands should be limited in the same manner as net operating loss carryovers. We would be pleased to work with the Committee in studying the difficult issues raised by built-in gains and losses.

Acquisitions by Loss Corporations

The proposal provides that the merger rule would apply to acquisitions by loss corporations in exchange for loss corporation stock, if the loss year shareholders own less than 80 percent in value of the loss corporation stock in the carryover year. This rule, which places some limits on the ability of a corporation with net operating loss carryovers to acquire other corporations that might produce taxable income against which the net operating losses can be offset, is similar to the provision in the proposal that limits a loss corporation's ability to issue new stock to third parties. In the case of new stock issues, no limitation applies if the loss corporation issues in any calendar year new stock worth less than 20 percent of the loss corporation's shares at the beginning of the year. In the case of an acquisition by the loss corporation, however, the 20 percent threshold, rather than being determined annually, is cumulative.

A loss corporation that intended to acquire other corporations would often do so by issuing new stock in any such transactions. Accordingly, we believe that the limitations on new share issuance should be parallel to the limitations on stock acquisitions and that the considerations referred to with respect to new stock issues should apply with equal force to acquisitions by loss corporations. We would be happy to work with the Committee in studying the issue and developing appropriate limitations.

Tax Classification of Partnerships with Publicly Traded Interests

The Staff would classify any limited partnership with interests traded on an established securities market as an association taxable as a corporation (the "classification proposal"). The report states in rather conclusory fashion that large, centralized business organizations ought to be subject to an entity level tax because of the similarity of these organizations to large corporations. In addition, the Staff expresses doubt about the adaptability of the partnership tax rules to the complexity presented by publicly traded limited partnerships. An unstated concern of the Staff may be that adoption of the other significant proposals in the report would increase the disparity between the taxation of partnership and corporate profits and thereby provide incentives for conducting in partnership form many activities presently conducted by corporations. The Treasury Department opposes the classification proposal.

Our principal objection to the classification proposal is that the classification of business organizations for tax purposes is a matter which involves tax policy considerations beyond the scope of this project. The proper classification and methodology for taxing publicly held limited partnerships are difficult questions which we think should be answered only after a thorough review of the taxation of all similar business organizations, including real estate investment trusts. We have serious doubt that after such an analysis one would conclude that the degree of marketability of an organization's equity interests should determine the manner in which the organization is taxed. We also are not convinced that access to a rational system of pass-through taxation should be restricted on the basis suggested by the classification proposal. As pointed out earlier in this statement, we are not prepared at this time to support proposals which significantly broaden the two-tier tax system of taxing corporate profits.

We also have some concern about the impact of the classification proposal on certain activities. The absence of an entity level tax appears to be a major factor in stimulating partnership capital formation. Many of the entities that would be affected by the classification proposal would be those which are seeking capital for natural resource exploration, research and experimentation and housing development. Any proposal that might reduce significantly the flow of capital into these ventures must be considered carefully.

The American Law Institute Federal Income Tax Project Tentative Draft No. 7 (1979), which is cited as support for the classification proposal, recommended as a general rule that unrestricted access to partnership status be permitted. Its suggestion to exclude publicly traded partnerships from this recommendation was based primarily on the perceived problems that the IRS would encounter in auditing these partnerships. We believe that many of these problems have been eliminated or substantially reduced as a result of the partnership level audit provisions contained in TEFRA. The administrative problem most often associated with publicly traded limited partnerships is the perceived difficulty in allocating various tax items among partners when there are multiple transfers of partnership interests during the taxable year or where partnership interests are held in street name. These allocation problems are faced to a greater or lesser degree by every partnership and we are not convinced that the mechanics of making these calculations are insuperable; nor are we aware of any significant abuses that have been linked to publicly traded limited partnerships. Indeed, we suspect that the reporting requirements imposed upon publicly traded and registered partnerships and the public scrutiny that these organizations receive make them less likely to engage in abusive activities than partnerships with fewer partners.

We also believe that the concern over a migration of corporations into partnership form is overstated. To date there has been no such large-scale movement notwithstanding that corporate earnings are subject to a more onerous tax regime. Such a move involves many considerations in addition to the Federal tax burden, including increased reporting and record-keeping requirements, and the uncertainties and state-to-state inconsistencies relating to the substantive law of partnerships.

For these reasons we must urge that the classification proposal not be adopted.

Finally, I would like to commend the Staff for its work to date. We look forward to working with the Committee and Staff on a continuing reevaluation of the corporate tax provisions of present law.

I would be pleased to answer any questions you may have.

WRITTEN STATEMENT

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SUBMITTED FOR INCLUSION IN THE PRINTED RECORD

OF THE COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARING ON THE ISSUE OF MASTER LIMITED

PARTNERSHIPS

JULY 21, 1987

Submitted
August 21, 1987

American Institute of Certified Public Accountants
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These written comments, which are being submitted on behalf of the American Institute of Certified Public Accountants, were formulated by the Executive Committee of the Federal Tax Division. The AICPA represents almost 250,000 CPAs, many of whom work on a daily basis with the partnership issues of the type discussed at the July 21, 1987 hearing.

We commend the Subcommittee on Taxation and Debt Management and Chairman Baucus for initiating a discussion on a topic which has become a subject of considerable interest to the Treasury Department and tax practitioners. The use of pass-through entities, such as partnerships, has grown increasingly in recent years and is today employed by both large and small businesses.

As a preliminary matter, it is important to differentiate between a master limited partnership (MLP) and other forms of partnerships. For purposes of our written comments, any reference to a master limited partnership is intended to encompass any partnership which is registered with the Securities and Exchange Commission and in which the units representing beneficial ownership are regularly traded on a recognized securities exchange, such as the New York or American Stock Exchanges. This is to be distinguished from a publicly registered partnership (i.e., a partnership required to file a registration statement with the Securities and Exchange commission, but whose units are not regularly traded on a recognized securities exchange) and nonpublic partnerships (i.e., those which are neither registered nor publicly traded). In considering any Federal tax legislation which may be proposed to affect MLPs, we strongly suggest that due consideration be given to any corresponding effects upon investors in publicly-registered and nonpublic partnerships.

HISTORY OF THE PARTNERSHIP CLASSIFICATION REGULATIONS

Form of business: While MLPs generally trace their origin back only to 1981, the partnership form of organization antedates the corporation. Indeed, the Internal Revenue Code and its predecessors have long given taxpayers a choice in structuring their businesses. Owners may choose generally to operate their businesses in any one of many forms, including proprietorships, partnerships, or corporations (including S corporations). Additionally, certain businesses may choose to operate under special rules adopted by the Congress over the years to encourage specified activities, such as Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), Small Business Investment Companies (SBICs), and, most recently, Real Estate Mortgage Investment Conduits (REMICs). Because taxpayers may structure their affairs in a way that minimizes their overall tax liabilities and provides a more desirable operational format, the distinction between such entities is critical for purposes of overall business and tax planning. As the distinctions between these entities have evolved under state law, court decisions and Treasury pronouncements, one principle has remained constant: there is a need for a clear line to be drawn between business forms so that the Treasury can adequately and efficiently administer the rules, and taxpayers can act with the necessary degree of certainty. In recent years, a great deal of attention has been focused by the Congress and the Treasury on the use of pass-through entities, such as partnerships, as tax-oriented investment vehicles. It is not without irony that the expanded use of the partnership form was made possible in large part by the Service's desire in the so-called Kintner regulations to favor partnership classification over the corporate form in order to curtail the growth of professional service corporations.

The Kintner regulations: Under the present classification regulations, an unincorporated entity is treated as a partnership for Federal income tax purposes if it has at least two of four partnership characteristics: limited life; unlimited liability; lack of centralized management; and an absence of interests which are freely transferable. These classification regulations have been in place for almost 20 years and have withstood the regulatory and judicial test of time.

Some commentators have suggested that one factor in the existing Kintner regulations should weigh more heavily than any other in determining the income tax classification of an entity. For example, the suggestion has been advanced that an entity should be treated for Federal income tax purposes as a corporation unless at least one member has unlimited liability for the debts of the organization. The Treasury attempted to adopt such a standard several years ago to deal with the so-called Wyoming Limited Liability Act entity. In those proposed regulations, the Treasury elevated the factor of limited liability and held that an unincorporated organization automatically would be treated as a corporation unless at least one member had this full unlimited liability. Those regulations were withdrawn, in part, because of adverse comments concerning the possible impact of the proposal on the proper tax classification of foreign entities. The point to be noted is that in the past when administrative efforts attempted a true resemblance test or elevated one factor over the three others, the Kintner regulations have been retained as the more reliable approach to the classification question.

PRIOR TREASURY CONCERNS REGARDING PARTNERSHIPS

Extensive legislative action by the Congress: In reaction to the growth of tax shelters prior to the enactment of the Tax Reform Act of 1986 (the "1986 Act"), the Treasury requested and the Congress responded over a period of years by enacting or revising numerous provisions of the Internal Revenue Code. Beginning with the passage of the investment interest expense limitations in the Tax Reform Act of 1969, the pace quickened with the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984 (the "1984 Act") and, most recently, and perhaps most comprehensively, the 1986 Act. The major anti-tax shelter provisions enacted by the Congress include: the at-risk limitations with respect to tax losses and credits; the passive activity loss limitations; and the partnerships level audit rules. In addition, the Congress has limited the options a partnership has in electing its method of accounting (I.R.C. §448), taxable year (I.R.C. §706(b)), and its ability to allocate items of income, gain, loss, deduction, and credit among the partners (I.R.C. §§704(b), (c), (d), and 706(d)).

Significant and numerous other amendments to the Internal Revenue Code have been adopted with more specific targets, including sections 189 and 263A (dealing with construction period interest and taxes), section 461(i) (certain prepaid items), section 464 (certain farming expenses), section 467 (the treatment of uneven rental payments), and section 709 (partnership organization and syndication expenses).

An additional and important point is that the partnership tax rules were extensively revised by the Congress in 1984. The professed objective of the provisions of the 1984 Act was to conform the partnership rules to the more modern use of the vehicle. It is noteworthy that the Congress did not choose to change the Kintner regulations at that time and, for the reasons stated below, we do not believe that it is appropriate to change the classification at this time.

In addition to the substantive changes made to the laws governing the taxation of partners and partnerships, the Congress has instituted a number of comprehensive administrative and compliance reforms. IRS examinations for partnership taxable years generally ending after 1982 are conducted at the entity level, greatly enhancing the potential audit efficiency and effectiveness of the IRS. Similarly, extensive reporting requirements and penalty provisions enacted since 1981 should improve the level of partner reporting of partnership items and resulting compliance with the tax laws.

Judicial activity: Separate and apart from this significant legislative effort, the courts (principally the Tax Court) have begun to reduce the extensive backlog docket of tax shelter cases. In instances where the court believes that the underlying transaction was uneconomic (separate and apart from the tax benefits) and/or a sham, it has had little difficulty finding against the taxpayers, not on the basis of recent legislation, but rather by use of general tax principles, such as the lack of economic reality of the transaction in question.

Summary: Any supposed historical bias of the Kintner regulations to encourage tax shelters should no longer be of concern to the Congress, simply because prior legislative efforts have substantially removed the impetus for tax shelter oriented limited partnerships.

SHOULD AN ALTERNATIVE LINE BE DRAWN?

In its report on tax simplification and reform dated November 1984, the Treasury proposed that all limited partnerships with more than 35 limited partners should be treated as corporations for Federal income tax purposes. The number 35 apparently was chosen to conform to the number of permitted shareholders in an S corporation. While such a bright line test has the benefit of absolute certainty, the question is at what point the line should be drawn. Should it be 35 limited partners? 100? 1000? Publicly registered partnerships traditionally have had several thousand partners. The mere fact of size has not appeared to hamper the Internal Revenue Service in its examination function since enactment of the uniform partnership audit rules. Indeed, the Treasury in testimony before the Senate Finance Committee in 1983 (the "1983 testimony") stated that master limited partnerships, because of the reporting requirements imposed upon them and the public scrutiny they receive, are less likely to engage in abusive activities than partnerships with fewer partners.

Should the fact that the interests are publicly traded change the result? If so, that would appear to penalize the creation of an efficient market system where all investors, large and small, have full knowledge of relevant information. In fact, Treasury in the 1983 testimony stated that marketability of ownership interests should not determine an entity's tax treatment.

Should one factor override all the other factors in determining the classification of an entity as a partnership versus a corporation? History teaches us that such an approach may prove unworkable. Moreover, the numerous recent refinements of partnership (and partner) taxation have substantially eliminated the potential for abuse of the partnership form.

GROWTH OF MLPS

MLP growth and limitations: The use of MLPs as a business form has certainly grown in recent years. It appears that some of the increased interest in MLPs has been generated by the changes made in the 1986 Act, specifically the repeal of the General Utilities doctrine and the reduction in 1988 of the top individual rate bracket (28 percent) to a level that is lower than the top corporate rate bracket (34 percent). More importantly, some of the current interest in MLPs arises from business considerations related to specific industries (*e.g.*, real estate and oil and gas), as opposed solely to income tax factors.

The typical buyer in an MLP appears, in general, to be an individual, as opposed to a corporate or institutional investor. The MLP thus affords the individual investor the opportunity to participate in many markets, such as commercial real property ownership, where he might otherwise be precluded due to lack of sufficient capital. While alternative vehicles are available, such as REITs, they lack the flexibility of the partnership form. Additionally, REITs lack the ability to actively manage their investments, thus precluding the REIT's shareholders from sharing in any appreciation attributable to direct managerial and operational efficiencies. Furthermore, the MLP format is not limited solely to the real estate business, a severe constraint imposed upon REITs.

It should also be noted that there may be natural limitations on the use of an MLP. In an MLP, the investors pay current Federal income tax on their respective shares of the annual earnings of the partnership. In the case of a corporate shareholder, however, no tax is imposed at the investor's level until the corporation distributes earnings to shareholders in the form of dividends. Thus, an MLP experiences tremendous pressure to make cash distributions to its partners on a current basis in an amount sufficient not only to help the investor pay the resulting tax liability on his share of MLP income, but also to yield the investor a net after-tax cash return. The current investment climate is such that MLPs are generally priced by the capital markets on a multiple of cash flow, rather than the traditional price/earnings ratio used to evaluate corporate stock. Thus, MLPs may not be appropriate for many corporate activities, especially those that need to retain earnings for growth or expansion. MLPs appear most appropriate for businesses with a fixed pool of investments that are self-liquidating or activities that have an established cash flow stream. These businesses encompass activities such as investments in real estate or oil and gas properties, or a discrete, established line of business in which the product or service generates a predictable stream of cash income and has low reinvestment requirements.

Revenue impact: A concern of the Congress and Treasury may be that the MLP form will result in a loss of anticipated tax revenues — that master limited partnerships will exacerbate an erosion of the corporate tax base. Indeed, on its face, such a concern seems warranted. This argument is intuitively sensible. There are, however, a number of factors which may mitigate such revenue loss, including the following:

- The repeal of the General Utilities doctrine, so that formation of one form of a "roll out" MLP generally results in a taxable event of relatively substantial magnitude. (In a "roll out" MLP, generally a corporation that wishes to distribute a line of business to its shareholders will contribute the business to a partnership in exchange for partnership units and then distribute a portion of the units to the shareholders as a dividend. The distributing corporation generally recognizes taxable gain under section 311(d), while the shareholders generally recognize dividend income to the extent of corporate earnings and profits. A second form of roll out MLP generally does not trigger taxable gain upon creation. However, the contributing corporation continues to hold its investment, so that the corporate level tax is preserved, albeit deferred.)

- The use of leverage by corporations to generate an interest expense deduction arguably acts to reduce or eliminate taxable income at the corporate level. As several commentators have noted, a corporation through the prudent use of debt may reduce or eliminate taxable income. If the creditor is a tax-exempt entity (e.g., a pension fund), not only is the interest expense deductible by the corporate borrower, but the interest income is not taxable. On the other hand, because an MLP must focus on the current distribution of cash to its partners, the MLP generally would be less likely to assume a fixed cash outflow, such as debt service.

- The profile of shareholders of the typical publicly held corporation versus the MLP investors appears to be significantly different. As indicated above, most MLP interests appear to be held by U.S. individuals. Thus, at least one level of taxation results. Conversely, a portion of America's corporate stock is owned either by tax-exempt investors, such as pension funds, or other corporations. A corporation's income is fully subject to both levels of taxation only if the corporation is profitable, it pays dividends, and the shareholder recipient itself is a tax paying entity. Moreover, if the shareholder is a domestic corporation, the shareholder level tax in 1988 cannot exceed a rate of 6.8 percent.

APPLICATION OF PARTNERSHIP RULES TO MLPS

Partnership taxation in general: Inasmuch as a partnership itself is not subject to Federal income tax, but rather the partners are directly taxed on their distributive shares of partnership income regardless of whether or not it is currently distributed, the effective tax rate applied to income from a partnership depends on the individual brackets of its partners. Tax losses and deductions similarly are passed through to the partners and may generally offset such partner's income from other sources. However, the partner's ability to use these losses and deductions is subject to extensive limitations, including the partner's basis in is partnership interest, the "at-risk" rules and the new, and highly significant, passive activity rules.

Use of the partnership form traditionally has allowed the partners to allocate tax burdens and benefits among themselves in any manner agreed to, but this flexibility is not without its restrictions. If the allocations of income or loss made by the partnership agreement do not correspond to the underlying economic benefit or burden, the partnership's items of income, gain, loss, or deduction are then allocated among the partners in accordance with their underlying economic agreement.

The Congress previously has responded to attempts by partners to shift among themselves partnership income or loss, as well as gain recognized by a partnership on the sale or exchange of assets contributed to it. Sections 704 and 706 virtually preclude the allocation of partnership items to a partner prior to his admission or subsequent to his withdrawal. Additionally, any "built-in" gain or loss on assets contributed to a partnership must be allocated to the contributor when the partnership disposes of the asset. Thus, the law precludes a shifting of inherent gain to a partner other than the contributor.

In other words, Congressional action and recent Treasury regulations make it practically impossible to ignore partnership economics when determining the way in which tax attributes should be shared by the partners. The tax consequences, quite simply, now follow the entity's economics.

Distinguish from taxation of corporations: A corporation, in contrast, is a separate and distinct taxable entity. Except in the case of an S corporation, corporate income and corporate losses are not passed through to the entity's shareholders. Rather, income is subject to tax at the corporate level. Similarly, net operating losses remain with the entity, where they may be carried over or back (subject to restrictions), and thus may offset prior or future taxable income. Distributions of money or other property are taxable to shareholders, but generally only when made and only to the extent of the corporation's earnings and profits. If the distributing corporation lacks earnings and profits, the distributions first act as a tax-free return of capital to the extent of the shareholder's basis in his stock. Distributions in excess of basis are taxed generally as capital gains. Thus, the two-tier corporate tax (often called "double taxation") is not currently applicable if the corporation makes no distributions (subject to the potential imposition of certain "penalty" taxes) or if it makes distributions but lacks earnings and profits.

While shareholders of certain corporations can elect to be taxed as a pass-through entity in a manner similar to a partner in a partnership, it should be noted that the S corporation rules are not identical to those of a partnership (in spite of the Subchapter S Revision Act of 1982). Thus, technical differences in the treatment of S corporation shareholders and partners continue to exist. A principal difference is the relative lack of flexibility an S corporation has in allocating items of income, gain, loss, or deduction among it shareholders vis-a-vis the partners in a partnership, as well as restrictions on the identity and number of S corporation shareholders. (Of course, both S corporation shareholders and limited partners have limited liability for entity debts.)

Partnership examinations: Perhaps, Treasury's concern with master limited partnerships is motivated, in part, by a belief that certain of the technical provisions of Subchapter K do not work in the instance of MLPs. Certainly, an MLP, at the entity level, experiences higher tax compliance costs than a corporation of similar size. This arises naturally as a consequence of the taxation of the MLP's income at the partner level. However, under the partnership level audit rules, the IRS examines an MLP at the entity level, and by dealing with the tax matters partner, makes adjustments to the partnership's taxable income or loss. These adjustments, in general, are binding on the individual investors. Therefore, the Treasury Department's concern cannot be that an MLP escapes IRS audit and scrutiny.

A separate concern is the level of compliance at the individual investor level. That is, even if the entity properly reports all items of income or loss to the IRS, is each partner reporting (and paying tax) on his distributive share of that income? Clearly, the Congress has previously enacted legislation that requires appropriate reporting to assure investor compliance, and it has seen fit to establish penalties for any failure to satisfy these reporting obligations.

The sophisticated computer programs used by master limited partnerships do, indeed, assure that all partnership income is allocated to the owners and reported to the owners and the IRS on Schedules K-1 of Form 1065. The daily trading of MLP units makes it impractical to revalue the entire partnership every time a unit changes hands, and as a consequence, the computer programs are typically based on some simplifying assumption. For example, the partnership may admit all purchasers for a given month as of a single date and assume that all purchases were made at the lowest bid or closing price during that month. Thus, while all income is allocated to the partners, there likely will be some de minimis differences in the amounts allocated to specific partners. If this is a deficiency in the exact compliance at the partner level, it would seem that it is a technical problem which should be the subject of administrative regulation rather than corrective legislation.

We understand that some members of Congress may wish to support a legislative change to impose a withholding obligation at the partnership level on distributions to the MLP's partners (other than those which are tax exempt). The AICPA does not take a position on such a proposal, but it should be remembered that each partner's share of MLP income is already subject to the estimated tax provisions currently in place.

The technical rules in an MLP context: With respect to the taxation of partners in a master limited partnership, the Treasury has expressed concern as to the level of technical compliance achieved by partners of an MLP. These technical issues primarily include the special allocation provisions of section 704(b); the existence of possible retroactive allocations (in violation of section 706); possible constructive termination of the partnership (under section 708); compliance with the rules governing contributions of appreciated or depreciated property (in accordance with section 704(c)); and the ability of an MLP to properly make the special basis adjustments allowed partnerships (sections 734(b), 743(b), 754, and 755).

First, we share Treasury's concern that an MLP's taxable income be properly reported. Over the past several years, a few firms have developed tax accounting and reporting systems which are designed to allocate to each partner his share of partnership items and to facilitate the reporting of those items to the appropriate partners and to the IRS. In general, these tax accounting systems make certain simplifying assumptions in methods of allocation. For example, while the MLP units may trade daily at varying offer and bid prices, the partnership may admit all purchasers for a given month as of a single date and assume that all purchases and sales were made at the lowest bid or closing price during the given period. As a result, the allocations made by the MLP may not satisfy the literal language of the statute. Nonetheless, as previously stated, all of the partnership income is allocated among the partners.

If the Service believes the allocations of income made by an MLP are not within the well-established bounds of the Code, the IRS, under its existing audit powers, is free to perform an examination under the uniform partnership audit rules and propose whatever adjustments it deems necessary. As a practical matter, if indeed all partnership items (income, deductions, gain, loss, and credits) are reported, any resulting adjustment will be to simply reallocate these items among the partners. These reallocations are likely to have only nominal impact on any partner and only nominal impact on the Federal revenue (perhaps even favorably).

Second, with respect to a specific tax accounting issue, an MLP may utilize a simpler tax accounting alternative afforded by the Code than a nonpublic partnership. For example, the partnership allocation regulations allow items of income, deduction, gain, loss, or credit to be specially allocated among the partners in a manner not fully proportionate with their stated interests in the partnership, provided that the allocations satisfy the complex test of "substantial economic effect." Many nonpublic partnerships make special allocations of partnership items where supportable under the regulations to maximize potential tax advantages to the partners. On the other hand, most MLPs do not make such disproportionate special allocations. Rather, they simply allocate items of income, deduction, gain, or loss to each partner is accordance with the partner's stated interest in the partnership. In short, because of their size, MLPs will adopt the most administrable allocation method in order to avoid the complexities inherent in special allocations. These allocation methods and the public disclosure requirements to which MLPs are subjected by the SEC, minimize any potential for abusive special allocations.

Certain areas, such as contributions of appreciated property and the technical termination of a partnership (if 50 percent or more of a partnership's interests in capital and profits are sold or exchanged within a 12-month period) create administrative problems for MLPs. However, the technical nature of these problems are the same for all partnerships, whether publicly traded, publicly registered, or nonpublic. Unlike many other partnerships, MLPs and their tax advisers are aware of these issues and generally have adopted procedures to monitor their compliance. However, there is no absolute assurance that technical compliance will always occur.

In summary, to the extent that MLPs or other partnerships do not achieve complete compliance with every requirement of the law, regulations and administrative pronouncements governing Subchapter K, there is some reason for concern. However, this lack of full compliance should not, in and of itself, justify changing the tax classification of MLPs. Rather, we would hope that the Subcommittee would work with Treasury to reduce present complexities for all partnerships. Further, we hope that minor compliance shortfalls, particularly those that result in minor misallocations among partners rather than underreporting of income, would not be given undue significance.

Imposition of an entity level tax: Some opponents of the pass-through nature of MLPs advance three primary arguments for the imposition of a corporate level tax on the entity. First, the allocations of income or loss made by an MLP fail to satisfy the technical rules of Subchapter K. As noted above, this problem appears to be one of noncompliance with hypertechnical rules, rather than one which signifies potential abuse.

Secondly, an MLP by definition avoids entity level taxation and thus is a form of "self-help" tax integration. Thus, they fear erosion of the corporate tax base. However, the investor mix of corporate shareholders versus partnership unitholders, the effective use of corporate leverage, the effects of tax exempt entities as owners, and other factors may mitigate in full or in part the revenue impact of a lack of an entity level tax on MLPs. Further, we believe that a comprehensive study of the concept of integration of our system of income taxation is still needed. Our 1976 Statement of Tax Policy, Elimination of the Double Tax on Dividends, may be helpful in analyzing the integration issue. The current discussion of MLP reclassification should not cause the Treasury to stop moving ahead with a broader study of integration.

Finally, proponents of MLP taxation argue that master limited partnership units in substance are traded like corporate stock, sold like corporate stock, and promoted by brokers like corporate stock. Therefore, MLPs should be taxed like the corporations that issue stock. Indeed, the unitholder in an MLP can check the value of his units in a newspaper or with a Quotron just as if it was any other publicly traded security.

Irrespective of this trading feature, there appear to be two distinguishing factors between the ownership of corporate stock and MLP units. First, the capital markets evaluate the two ownership interests in very different ways. Corporate stock frequently trades based upon a multiple of anticipated earnings, the price/earnings ratio. MLP units, however, are often valued as a function of anticipated cash distributions. Of course, projected earnings are not synonymous with anticipated cash distributions.

A second distinguishing feature of MLPs is the current inclusion in a partner's taxable income of the partner's distributive share of partnership income. In each MLP every partner runs the risk of reporting current partnership taxable income (of varying types and character) without sufficient current cash distributions to pay the resulting tax liability. As discussed above, the corporate shareholder incurs no tax liability until there is a distribution and then only if the distribution is out of corporate earnings and profits.

These relatively significant differences between MLP unit and stock ownership exist, regardless of how the units may be promoted by retail brokers. Indeed, any confusion on the part of a retail purchaser is quickly dissipated upon receipt of the purchaser's first Schedule K-1 from the MLP.

Income characterization: Since the passage of the 1986 Act, the characterization of income as "passive" or "portfolio" income has become more significant. In the MLP area some commentators have suggested that all MLP income should be considered passive, while others believe it should all be portfolio income. This commentary focussing on master limited partnerships as passive income generators has caused some members of the Congress and officials of the Treasury to voice a concern that a significant revenue loss may result if MLPs do indeed generate passive income. The AICPA does not take a position at this time on this passive versus portfolio issue. However, it may well be that a more equitable approach would be to characterize the income according to the nature of the underlying asset or activity. This would be consistent with the long-time requirement that partnerships identify the nature of income and deductions that flow through to the owners when the character of such items may have relevance at the partner level. (c.f. IRC § 702(b))

SUMMARY

The AICPA believes that any proposal to change partnership classification should not depend simply upon the number of partners or the manner in which partnership interests are sold or exchanged. Rather, we believe that partnership classification should continue to be appropriate for MLPs. We believe the treatment of MLPs should not be altered without due consideration of the other issues that bear on the integration of our tax system; those issues should be considered and resolved in an orderly and comprehensive fashion. The MLP classification issue is simply one of these issues that happens to be more visible to the Subcommittee at this point in time.

We thank the Subcommittee for its willingness to consider our views, and we would be happy to work with the subcommittee and staff to identify and seek elimination of unnecessary complexities of present partnership taxation as it may impact on both large and small partnerships.

STATEMENT
ON
MASTER LIMITED PARTNERSHIPS
for submission to the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
of the
SENATE COMMITTEE ON FINANCE
for
ARTHUR ANDERSEN & CO.
By
Richard A. Gordon*
July 21, 1987

OVERVIEW

In response to congressional interest in the current tax treatment of master limited partnerships (MLPs), Arthur Andersen & Co. has prepared an analysis of the key issues that should be considered in the course of the debate. A report, based on that study, has been prepared and is submitted as an exhibit to this statement. The report does not attempt to evaluate whether the existing regulations distinguishing between corporations and partnerships are appropriate or satisfactory. Indeed, that issue does not appear to be the focal point of the public debate. Rather, the report considers whether the formation of MLPs threatens to erode Federal tax revenues and whether MLPs can be justified as a proper form of business organization.

Those concerned about revenue loss, inevitably assume that more tax revenue would be collected from a two-tiered system of taxation than from a single level of tax. Viewing MLPs as corporations in disguise, they contend that significant revenues could be raised by taxing MLPs "like corporations" and imposing tax both on the MLP and its investors.

Our conclusion is that this concern over an MLP-induced threat to Federal revenues is greatly exaggerated. Based on an analysis of MLP operations and on a systematic review of the dual level of taxation at the corporate and shareholder levels, it appears that MLPs do not cause a substantial erosion in the Federal tax base. In fact, depending on how much tax revenue is collected on the transfer of appreciated property, tax revenue may actually be enhanced by the formation of MLPs. Thus, on a tax-revenue basis, the report concludes that a change in the present-law tax treatment of MLPs is neither necessary nor appropriate.

An MLP, like any other partnership, is organized and governed by state law. The main distinction between an MLP and any other limited partnership is that MLP units are traded on an established exchange. This facilitates the movement of capital in the economy and benefits both MLP sponsors and potential investors. Notwithstanding dire claims of a "proliferation" of

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MLPs, as of March 31, 1987, only 83 had been formed since 1981. While most MLPs were formed in the economically-depressed oil and gas and natural resources industries, many recent MLPs have been formed in the real estate,construction, and investment industries. As of March 31, 1987, MLPs had an aggregate market value of $31.2 billion, with nearly 70 percent of that value still held by the original corporate sponsors.

Some have expressed the concern that the Tax Reform Act of 1986, by lowering the top individual rate below the top corporate rate, has created a further incentive for corporations to convert to MLPs. In fact, while under the old law the potential net return to an investor was as much as 85 percent better in a partnership than in a corporation, under the new law the potential benefit to an investor has been reduced to 52 percent. This reduction in the potential advantage that a partnership has over a corporation can hardly be the cause of a stampede to form MLPs.

Of the various concerns expressed by MLP opponents, the threat to Federal tax revenues has probably received the most attention. In a two-tier corporate-shareholder system of taxation, corporate earnings are taxed at the corporate level and are taxed again when distributed to shareholders. An MLP, in contrast, is not taxed at the entity level, but its unit holders are taxed currently on their share of the MLP's income. This difference in treatment, however, does not mean that substantial revenue could be raised by applying an entity-level tax to an MLP as if it were a corporation. There are a number of reasons for this conclusion.

- MLPs are not suitable for all sectors of the economy or for all types of business. Thus, an explosion of MLP formations is unlikely.
- Notwithstanding separate corporate and shareholder taxes, not all corporate income is taxed twice. About 50 percent of corporate earnings are retained for reinvestment and, thus, are not taxed currently as dividends at the shareholder level. Moreover, some corporate income is paid out as deductible interest expense and, thus, is not even taxable at the corporate level.
- Not all corporate income that is paid out is taxed to the recipient. Tax-exempt institutions, such as pension funds, are significant holders of corporate stocks and bonds. These entities do not pay tax on their receipt of dividends or interest.

Since not all corporate income is taxed at both the corporation and shareholder levels, it is highly unlikely that all MLP income would be taxed twice if MLPs were taxed as corporations. Thus, the revenue potential from a change in the law would seem minimal at best.

The notion that the formation of an MLP by a nonliquidating corporation constitutes "disincorporation" is simply wrong. A corporation that forms an MLP from its existing operations, does not remove productive assets from the corporate-tax system. It retains the value of those assets either in the form of MLP units, or it receives the economic equivalent in the form of sales proceeds. In either case, the same potential for producing income continues to reside within the corporation.

Rather than being a device to avoid the corporate-income tax, MLPs play a positive role in the U.S. economy. Consistent with the theme of economic efficiency trumpeted by supporters of the Tax Reform Act, MLPs can be viewed as a form of business organization that is good for the economy, one that increases national output by improving the allocation and use of economic resources. In particular, MLPs have four desirable characteristics:

- o MLPs provide an incentive to distribute cash to investors that might otherwise be invested in a less economical fashion;
- o MLPs channel investment funds to their most productive use, they facilitate growth and productivity, and provide unit holders with a more secure and certain return on their investment.
- o MLPs provide the MLP-intensive sectors of the economy with a source of capital comparable to that which the corporate sector acquires through internal finance or access to pension funds and other tax-exempt entities; and
- o MLPs improve liquidity and reduce the risk of bankruptcy in an activity by curtailing the level of debt.

Evidence from the oil and gas and real estate industries demonstrates that assets may be valued more highly when held by an MLP than by a corporation. The basis for this premium valuation is that, because of a favorable distribution policy, MLPs give investors greater confidence that they will actually receive the cash flow generated by their investment. The increase in asset value associated with the formation of an MLP enhances the ability of the corporate sponsor to raise capital in an efficient manner, facilitates the acquisition of other property, and protects the corporate sponsor from an unfriendly takeover challenge by ensuring that its stock reflects full market value.

In addition to a revenue concern, those who propose changing the current tax treatment of MLPs contend that MLPs have an unfair competitive advantage over those businesses operating as corporations. Perhaps equating size and tradeability with corporate similarity, this view overlooks the fact that MLPs are legally, functionally, and economically different from corporations. While as of March 31, 1987, 83 MLPs had been formed since 1981, it is far from certain that a wholesale shift from the corporate to MLP form of business is imminent.

The formation and operation of MLPs involves cash distribution requirements, front-end tax charges, and a loss of management control that would be objectionable to much of the corporate community. Though MLPs are criticized as an example of ad hoc corporate integration, in fact, do-it-yourself integration has long been available to the corporate sector through the use of debt and tax-exempt financing.

IMPACT OF MLP FORMATIONS ON FEDERAL TAX REVENUES

Potential Revenue Loss

As a separate entity, the corporation is subject to taxation on its earnings. In a dual corporate-shareholder system of taxation, corporate earnings are again fully taxed when they are distributed to an individual shareholder. In contrast, an MLP does not pay an entity-level tax. Its earnings are subject to tax at the unit holder level whether or not actually distributed, but the earnings are not taxed a second time when actually received by the unit holder. Critics of current-law tax treatment argue that an MLP cannot be distinguished in substance from a corporation and that this ability to avoid entity-level tax therefore reduces the combined tax on corporate earnings. Consider the following example comparing the situation before and after enactment of the Tax Reform Act:

> The maximum individual tax rate was 50 percent and will be 28 percent while the maximum corporate tax rate was 46 percent and now is 34 percent. A corporation and an MLP each have $100,000 of taxable income. Compare the after-tax results to the individual investor.

	Old Law	New Law
Corporation		
Earnings	$100,000	$100,000
Corporate Tax at Top Rate	(46,000)	(34,000)
Net Available for Dividends	$ 54,000	$ 66,000
Personal Tax at Top Rate	(27,000)	(18,500)*
Net Investor Return	$ 27,000	$ 47,500*
Partnership		
Earnings	$100,000	$100,000
Personal Tax at Top Rate	(50,000)	(28,000)
Net Investor Return	$ 50,000	$ 72,000
Incremental After-Tax Return to a Partnership Investor	$ 23,000	$ 24,500*

(*Rounded)

The example clearly illustrates the potential tax savings ($23,000 under prior law and $24,500 under current law) available to an individual investor in an MLP compared to an individual shareholder in a corporation. However, this approach oversimplifies the potential impact of MLPs on Federal tax revenues, for at least two reasons. First, the example assumes that the corporation pays tax on all of its income at the highest corporate rate. In fact, many corporations do not pay tax at that rate. Through the use of debt, incentive credits, and other tax and financial planning, many corporations actually pay tax at a much lower effective rate. Second, the example assumes that 100 percent of the corporation's after-tax earnings are immediately distributed as dividends and are taxed at the highest marginal individual rate. This assumption, likewise, is questionable because (1) corporations typically retain a significant portion of their earnings for reinvestment, and (2) not all recipients of dividends pay tax, at least not at the highest individual rate. Tax-exempt institutions such as pension funds, for example, pay little or no tax on their dividend or capital gain income and are important investors in the corporate marketplace.

Realistic Revenue Impact

Our purpose in discussing revenue impact is not intended to provide a revenue estimate of a change in the tax treatment of MLPs. The ultimate responsibility, expertise and information to do this belongs to the revenue estimators at the Joint Committee on Taxation and the Treasury Department. Rather, the purpose of this discussion is to raise some issues to be considered in making these estimates, to provide new information, and to present some of the factors that the public debate may have overlooked in arguing that MLPs cause a significant drain on revenues. Careful analysis of the tax consequences associated with the formation and operation of MLPs indicates that the concern over a revenue loss, as compared to operating through a taxable entity, is greatly overrated and there may actually be a net revenue gain.

Factors in Assessing Revenue Impact

A number of factors must be considered in assessing the revenue impact of MLPs. At first glance, it is tempting to conclude that MLPs involve a revenue cost to the U.S. Treasury because a two-tiered tax levied on corporations and the corporation's shareholders would seemingly raise more revenue than a single-level tax imposed only on the investors or owners of a partnership. More specifically, identifying the revenue impact of MLPs necessitates answers to the following questions:

- How much revenue presently is collected at the investor level from MLP unit holders?

- How much revenue would be collected first at the entity level and again at the investor level if a dual-level of tax were imposed on MLPs analogous to the present law tax treatment of corporations and shareholders?

In comparing the answers to these two questions, it is not obvious that a dual level of tax would collect more revenue than current law treatment of MLPs because, as explained below, not all of the income generated in the corporate sector is subject to tax at both the corporate and shareholder levels. In fact, some corporate income is distributed to tax-exempt organizations in the form of deductible interest and is, therefore, not taxed at all. Thus, it is doubtful whether applying an entity-level tax to MLPs would result in full taxation of MLP income at both the entity and investor level. While it is possible that the revenue cost associated with MLPs might be more significant if a massive shift from the corporate form of doing business were to develop, it is unlikely that such a shift will occur.

A revenue estimate based upon an assumption that the MLPs will become subject to a two-tier tax must assume that some portion of gross income of the entity will be taxed at the 34 percent corporate or entity rate and that some portion of the amount remaining after payment of entity-level federal and state taxes will be distributed to investors and taxed again at the recipient level. In order to compare the present level of tax revenue collected from MLP investors with the revenue collected under a dual system that would treat MLPs "like corporations," there are at least four items for which estimates must be made:

- The number of entities that would operate as MLPs as opposed to corporations assuming no change in the law, and the tax revenue collected from the investors.
- The percentage of gross income that would be subject to tax at the entity level under the proposed change in law.
- The percentage of income that then would be distributed to investors.
- The percentage of that income that would be taxed to the recipients of the distributions.

These questions are difficult to answer because they raise a series of "what if" issues. Still, some tentative answers can be drawn from the manner in which the current tax system operates at the corporate and shareholder levels.

Number of MLPs

We were able to identify 83 MLPs that were publicly traded as of March 31, 1987. See Appendix D to the accompanying report. While it is impossible to estimate with any precision the number of MLPs that will be created within the next several years, the question really becomes whether there is a reason to suspect that a significant growth in the MLP sector will occur. It is our belief that while the number of MLPs will continue to grow, the number of MLPs as a percentage of all publicly traded entities should not be significantly greater then what it is today. See Section VI of the accompanying report. Even if there would be a significant increase in the portion of total income earned by MLPs, the following discussion indicates that it is unlikely that there would be a large loss in Federal tax revenues.

Corporate Level Tax

If MLPs are treated as taxable entities, i.e., "like corporations," will there be a substantial increase in corporate or entity-level revenue collections? While there may be some increase, a significant revenue increase depends on the further assumption that a large portion of revenues of corporate entities are fully subject to a 34 percent corporate tax at the present and that most MLP income escapes corporate-level tax. Neither of these assumptions is valid today. The primary reason that the first assumption is not valid is that the corporate tax is reduced by interest deductions generated by borrowing. The primary reason that the second assumption is not valid is that a large percentage of MLP units have been retained by the corporate sponsors and the earnings on those units are, therefore, still subject to a corporate level tax.

Debt substitute -- Many corporate transactions, including leveraged buy-outs, make extensive use of borrowing. Businesses are willing to borrow to such an extent for several reasons, but a major factor is that highly leveraged acquisitions reduce corporate taxes. The tax benefits associated with debt financing reduce its net cost and make debt less costly than equity financing.

From the U.S. Treasury's perspective, debt financing can cause a net loss of tax revenue. This is because income of the borrower, which is paid out in the form of interest expense, is "sheltered" from taxation by the deduction for interest, but there is not necessarily a corresponding increase in taxable income to, and tax paid by, the lender. For example, the debt financing can be, and very often is, provided by tax-exempt institutions such as pension funds, or other lenders that are able to shelter their taxable income through the use of special deductions and incentive credits.

MLPs are very often used as a substitute for conventional-debt financing. Indeed, the evidence suggests that this is the predominant use of MLPs. Equity raised from the limited partners is used instead of debt financing to acquire new assets or it substitutes for debt that the corporate sponsor would otherwise have incurred by pledging its assets. In other cases, equity raised when the MLP is formed is used to reduce corporate debt that is secured by assets that are transferred to the MLP by the corporate sponsor. In all of these instances, the MLP income that is allocated to the unit holders should be properly viewed as income that would have been paid by the corporate sponsor to third-party creditors. The revenue implications of this fact are important.

Instead of paying interest to tax-exempt or low-tax rate creditors, the corporate sponsor has, in effect, allocated income to taxable, individual unit holders. Thus, it is likely that there is an increase in revenues to the U.S. Treasury. At the very least, tax revenues are unaffected by the substitution of the MLP vehicle for conventional debt financing. Revenues are certainly not adversely affected.

While MLPs can and do borrow, the facts show that MLPs rely primarily on equity financing. MLPs listed in Appendix C of the accompanying report had debt equal to only 21 percent of their market value as of the end of 1986. The 15 largest MLPs had a debt-to-capital ratio of 16 percent as of the end of 1986.

MLP units retained by corporate sponsors -- The argument that the use of an MLP avoids all corporate-level tax assumes that all units are held by individual shareholders. The empirical evidence as of March 31, 1987, shows that, in fact, a large percentage (70 percent) of the value of all MLP units are still held by the sponsor corporations. Thus, the income allocated to 70 percent of those units is subject to tax at the corporate level and is subject to the two-tier tax to the same extent as other corporate income. Based on this finding, it seems reasonable to expect that, as MLPs are formed in the future, a substantial portion of their income will still be subject to the two-tier system of taxing corporate income.

Income Distributed by Publicly Traded Corporations

Even under the two-tier tax system, all corporate earnings are not currently taxed twice, once at the entity level and again at the shareholder level. This is because a significant percentage of corporate earnings are retained for internal financing purposes. In fact, about 50 percent of corporate earnings were distributed to shareholders over the 1980-1983 period. (Statistical Abstract of the United States, 1985, p. 532.)

MLPs also retain some of their earnings and could retain all of them, but in either case the unit holders pay the tax. The important point is that if corporate retained earnings are compared with the earnings of an MLP the difference in revenue is not between a two-tier tax and a single tax, but is the difference between the corporate tax rate and the individual rate.

Taxability of distributions -- The next issue is whether the approximately 50 percent of corporate earnings that are distributed are taxed to the shareholder at a high rate. The answer is that a significant percentage are not. Distributions to individual shareholders are, in general, subject to tax, but not all dividends are taxed at the top individual tax rate. In 1983, for example, 58 percent of dividend income received by individuals was reported on returns having less than $75,000 in adjusted gross income. As an illustration of the marginal tax rate paid by these dividend recipients, about 65 percent of those in the $50,000 to $75,000 bracket of adjusted gross income paid tax at less than a 28 percent marginal rate. (IRS Statistics of Income Division, Individual Tax Returns 1983, Washington, D.C., November, 1985, pp. 84-86.) A significant portion of corporate distributions, however, are also made to tax-exempt shareholders who do not pay a second tax. According to Federal Reserve System Flow of Funds data, for example, tax-exempt institutions and insurance companies owned about 25 percent of corporate equity in 1980. (King and Fullerton, The Taxation of Income from Capital, National Bureau of Economic Research, 1984, p. 240.) Finally, corporate shareholders are entitled to exclude 80 percent of the dividend from taxable income.

MLP units, other than those retained by the corporate sponsors, are held as an investment almost exclusively by individuals largely because institutions effectively cannot invest in MLP units. A significant percentage of the equity of publicly traded corporations is held by tax-exempt institutions such as pension funds and charitable organizations. MLP units are not held by these organizations because of potential exposure to the tax on unrelated business income. Therefore, while partners in MLPs must report MLP taxable income currently without the benefit of any special exclusions or exemptions, many shareholders of publicly traded corporations do not pay tax on the dividend income they receive.

Inability to Shift Appreciation Outside Corporations

The accompanying report describes the tax consequences associated with a transfer of assets outside of the corporate entity for each MLP type. (Appendix A of the accompanying report describes these MLP types in detail.) As the report states, the formation of the MLP may be tax free because the assets of the MLP are still in corporate solution in the form of partnership units held by the corporate sponsor. Any distribution of the units or sale of the units by the corporate sponsor will be taxed to the corporate sponsor. The Tax Reform Act of 1986, by repealing the General Utilities doctrine, makes this tax very significant and impossible to avoid.

These characteristics and their positive impact on the U.S. economy are discussed in some detail in the report.

ECONOMIC ROLE OF MLPs

Introduction

Though MLPs are criticized by some as a device to avoid the corporate income tax, excessive attention to this criticism is open to question for two reasons. First, as illustrated above the formation of MLPs does not appear to result in a substantial erosion of the Federal corporate tax base. Secondly, the criticism overlooks the important fact that MLPs play a positive and beneficial role in the U.S. economy. The debate on the Tax Reform Act of 1986, stressed the need to improve economic efficiency, especially the productivity and use of the nation's capital stock.

Consistent with this efficiency theme, MLPs can be viewed as a form of business organization that is good for the economy, one that increases national output by improving the allocation and use of the economy's resources. In particular, MLPs have four desirable characteristics:

- MLPs provide an incentive to distribute or pay out to investors cash that might otherwise be invested in a less economical fashion;
- MLPs contribute to a more efficient allocation of investment capital by channeling investment funds to their most productive use;
- MLPs provide the MLP-intensive sectors of the economy with a source of capital comparable to that which the corporate sector acquires through internal finance or access to pension funds and other tax-exempt entities; and
- MLPs improve liquidity and reduce the risk of bankruptcy by curtailing the level of debt in the economy.

Distribution Incentive

Over 50 years ago, Adolph A. Berle and Gardiner C. Means, writing in The Modern Corporation and Private Property recognized that the corporate form of business organization was plagued by a problem they described as the "separation of ownership and control." More recently, Michael C. Jensen, Eugene F. Fama, and William H. Meckling have been in the vanguard of those corporate finance specialists who have analyzed the characteristics of the separation of ownership and control issue, or what is also called the "agency" problem.

On one level, the separation of the ownership and management functions can be viewed as a salutary occurrence in that it creates mutual benefits by allowing shareholders to diversify their investment portfolios and professionally qualified managers to run the business. But the separation may also create difficulties because, according to those who have studied the "agency" problem, the two groups may not have congruent or identical interests.

Free-cash flow problem — While this agency conflict between shareholders and management may exist in any large corporation, it can be particularly troublesome in those industries or sectors that generate substantial cash flows, but have modest growth prospects for reinvesting that cash, what some have described as a free-cash flow problem.

According to one corporate finance expert, "conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free-cash flow. The problem is how to disgorge the cash rather than investing it below the cost of capital or wasting it on organization inefficiencies."

MLPs as a response to the cash-flow problem -- MLPs are one solution to the free-cash flow problem. MLPs provide managers with an incentive to "disgorge the cash" because, to facilitate the sale of MLP units, unit holders must be promised a minimum cash return on their investment. MLP organizers, according to the cash-flow argument, recognize the concern of unit holders that the return on their investment may be dissipated through unprofitable investments made by those managing the MLP. As a consequence, MLP managers generally agree to pay out a large proportion of the cash flow generated by the investment to the unit holders.

Improved Allocation of Investment

MLPs improve the efficiency of the capital market by directing investment capital towards its most productive use. Because the earnings of an MLP are distributed, MLPs help prevent the cash flow from being invested in unproductive projects. According to the agency view of corporate-shareholder relations, the investors are likely to reinvest the money more productively than if the decision is left to the corporate managers, who may not have the same interests as the shareholders.

Source of Investment Capital

MLPs are concentrated in certain sectors of the economy, such as real estate, oil and gas, and the timber industry. Thus, MLPs serve as an important source of financing for those sectors of the economy in which the corporate form of business organization may not be suitable.

Retained earnings, debt finance, and tax-exempt financing are recognized as legitimate vehicles for avoiding the full impact of the income tax at both the corporate and shareholders levels in those types of business activities in which the corporate form is the most appropriate vehicle. These sources of financing, however, are not readily available to the MLP sector.

Consequently, the MLP vehicle provides a source of financing that, like earnings retention, debt, or tax-exempt financing in the corporate sector, subjects the income to a single level of taxation. Just as the corporate sector seeks sources of financing in which the dual corporate-shareholder taxes are avoided, MLPs provide a parallel opportunity for those sectors of the economy in which the corporate form may not be suitable.

Reduced Use of Debt Finance

MLPs increase liquidity and reduce the risk of bankruptcy by curtailing the amount of debt in the economy. This is a significant contribution given the increasing reliance on debt in the corporate sector. In order to successfully market MLPs, unit holders are usually assured a minimum in cash flow from the investment. Since interest payments would reduce that cash flow, MLPs have relied primarily on equity finance and avoided heavy debt commitments.

In addition to relying mainly on equity finance, MLPs reduce the aggregate level of debt in the economy since the proceeds from an MLP issue are often used to extinguish debt held by the general partner or to purchase property that might otherwise be debt financed. This point is illustrated in Appendix D, which shows that in 1986, virtually all of the $2.5 billion of capital that was raised for the listed MLPs was used to buy property or extinguish debt.

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Statement For the Record
COOPERS & LYBRAND

Before The Senate Committee on Finance
Subcommittee on Taxation and Debt Management

Hearing on Master Limited Partnerships

July 21, 1987

Assistant Treasury Secretary J. Roger Mentz has testified before the Select Revenue Subcommittee of the House of Ways and Means Committee as well as this Subcommittee on the subject of Master Limited Partnership (MLPs). In his testimony, Mr. Mentz has expressed the Department of Treasury's concerns about MLPs which we will summarize as follows:

1) A concern that MLPs pose administrative difficulties which make compliance with the tax laws and regulations difficult;

2) A belief that MLPs possess a competitive advantage over businesses operating in corporate form;

3) A concern that the use of MLPs will expand rapidly with a resultant erosion of the corporate tax base.

The Senate Finance Subcommittee on Taxation and Debt Management will hear from many other commentators on Treasury's concerns described in points 2 and 3 above. Coopers & Lybrand would like to comment on Treasury's concerns described in point 1 above regarding the administrative difficulties posed by MLPs. As an international accounting firm, Coopers & Lybrand has provided accounting, tax and system consulting services to thirty five publicly traded partnerships since 1981.

Since 1981, the single most frustrating aspect of tax reporting for an MLP has been "street name ownership". That is, how does one furnish a K-1 to each of the partners who owned interests in an MLP during the year when the general partner doesn't know who they are? Our clients have invested considerable dollars and time attempting to penetrate street name ownership. By sending out requests for information to nominees who in turn have passed the requests on to the beneficial owners of partnership interests, our clients have been successful at identifying a significant percentage of these interest owners. This effort, when coupled with the use of per unit per month tables, has resulted in most partners receiving tax information. The process has, of course, not been 100% effective or 100% accurate.

With the enactment of IRC Section 6031(c) as part of the Tax Reform Act of 1986 (the Act), Congress has provided the mechanism to eliminate the problems associated with street name ownership. Section 6031(c) and Advance Notice 87-10, require nominees to furnish beneficial ownership information to publicly traded partnerships so that tax information can in turn be furnished directly to the interest owners. Section 6031(c) has resulted in significant system modification efforts being undertaken by the nominees. Additionally, representatives of the nominees, the MLPs and the accounting firms have participated in a series of meetings designed to facilitate the development of a "clearing house" system to collect the data from all nominees and disseminate the appropriate information to each individual MLP on a timely and convenient basis.

While still under development, the systems being implemented in response to Section 6031(c) should significantly improve an MLPs ability to furnish each partner a K-1. Once the systems being developed by the nominees and the MLPs to comply with Section 6031(c) are in place, the Internal Revenue Service will also have the ability to undertake a document matching program to test and improve compliance in this area, making any special withholding scheme unnecessary.

Aside from now knowing who all the beneficial owners are and thus enabling the partnership to provide each partner with a Schedule K-1, what impact will nominee reporting have? Specifically it will simplify compliance in three existing problem areas: terminations of partnerships under Section 708(b), adjustments required where a Section 754 election is in effect, and reporting of ordinary income under Section 751. Certainly, by requiring the nominee to provide the necessary information about the beneficial owner, the partnership can now more easily account for 100 percent of its ownership and monitor changes determining if and when 50 percent or more of the partnership interests have been sold or exchanged within a 12 month period constituting a technical termination. Once the partnership knows the event has occurred, it may then comply with the requirements prescribed in Subchapter K for such an event.

As previously mentioned, even prior to nominee reporting, MLPs made a good faith effort toward providing beneficial owners some tax information. The MLPs customarily provided nominees tables with per unit per month tax results which, if forwarded to the beneficial owner through the nominee, enabled him to construct his K-1 information and report his distributive share. This approach, however, had limitations where a Section 754 election had been made requiring adjustment under Sections 734 and 743. The adjustments are determined in part by the partner's purchase price for his interest. Where the partners were unknown, and, therefore, they received tables instead of individually prepared Schedule K-1s, a simplifying assumption was required with respect to the adjustments provided in the tables. The assumptions were conservative and in most instances produced results not materially different from what actually would occur. Nominee reporting should eliminate any need for assumptions since actual prices paid for partnership interests may be obtained and thus actual outside tax basis determined.

In the past there has been concern over the ability to properly apply Section 751 to publicly traded partnerships because the partner has insufficient knowledge regarding the partnership's property. Even before the Act's impact, we do not believe the problem with Section 751 was as extensive as Treasury perceived. There were some deficiencies, however. As previously mentioned, MLPs have provided nominees with per unit tables. A limitation of those tables has been that the actual amount of Section 751 income which is often unique to a given partner could not be reported accurately. As a practical matter, most partners in any partnership will only have sufficient knowledge to comply with Section 751 if the partnership provides them such information. Curiously, current law and regulations do not appear to expressly require the partnership to provide this information. Admittedly, with as many transfers as occur in a publicly traded partnership, providing such information might seem a monumental task. In an attempt to insure compliance wherever possible, most MLPs voluntarily provide such information to the partners when an interest is transferred. This practice goes far beyond what most other partnerships (whether small or large) customarily provide and apparently beyond what the law even requires of the partnership.

As is the case with the Section 754 election, the Act through nominee reporting should eliminate the problem with Section 751 that existed with the street name investors. When the partnership can account for all partners and all sales or exchanges, it can report the appropriate amount of Section 751 income. Additionally, the elimination of the preferred rate for capital gains by the Act eliminates the impact of Section 751 for most partners.

Another concern has been the perceived conflict between fungibility and compliance with Section 704(c) where the partnership has contributed property with a value different from its tax basis. A substantial part of the difficulty in complying with Section 704(c) emanates from the absence of regulations offering sufficient guidance. Taxpayers and practitioners are left to interpret for themselves precisely what Section 704(c) does or does not require in the way of compliance. The legislative history directs one to rely upon the regulations under old law where Section 704(c) was elective. Given the mandatory nature of this provision under current law, a set of examples are required that are more comprehensive than the few simplistic examples provided in the existing regulations. The legislative history also makes it quite clear as to the intent of Section 704(c). We as practitioners are satisfied that MLPs have implemented methods of allocation that comply with the spirit of the statute and protect the Treasury from unintended revenue loss while also preserving the critical tax fungibility required for the interests to be freely tradeable.

Certainly, one specific need that an MLP has and that volume tends to aggravate is the computation of each transferee partner's basis adjustments where the partnership has made a Section 754 election. The frequency with which such adjustments must be made and the number of assets over which the adjustments must be allocated are precisely why an MLP must have specially designed computer programs. These programs are capable of calculating and allocating the adjustments with great accuracy and without relying upon simplifying assumptions. Thus the concern expressed by the Department of Treasury can and will be addressed.

Perhaps more traditional tax accounting and reporting systems are inadequate to deal with the volumes presented by the MLP. Fortunately, MLPs are not required to rely upon these methods or systems. Sophisticated software has been developed to accommodate the specific needs of an MLP and particularly those needs that are unique to the problems of high volume. Indeed, it has been observed that the reason MLPs did not exist before 1981 was because computer technology had not advanced to a stage where these complexities could be handled in a cost effective manner.

Compliance concerns have also been raised about the practicality of collecting tax deficiencies from thousands of partners several years subsequent to filing of returns. While not a perfect answer, the collection of any deficiency at the partnership level seems to be the simplest and most effective approach.

Conclusion: Mr. Chairman and Members of the Subcommittee, this concludes our written presentation. We would be happy to address at any time, further questions that the Committee or its staff may have. James Lovett of our Dallas office is the partner in charge of the MLP client base in Dallas and is very knowledgeable on the systems that have been developed to facilitate tax compliance (214-754-5102). Tax partners experienced in MLP issues include John Furst, the Regional Tax Director for Coopers & Lybrand's Southwest Region (214-754-5250) and Alan Barber, again of our Dallas office (214-754-5245).

Statement of Edward C. Oelsner, III
Before The
United States Senate
Committee on Finance
Subcommittee on Taxation and Debt Management
Hearings on the Issue of Master Limited Partnerships
July 21, 1987

My name is Edward C. Oelsner, III. I am a Managing Director in the Investment Banking Department of Dean Witter Reynolds Inc. (DWR). As an investment banker for 19 years, my primary role has been to assist companies in raising long term capital in the most efficient manner possible. My first association with a master limited partnership (MLP) commenced with Transco Exploration Partners, Ltd.'s offering of partnership units to the public in July 1983, and I have devoted a major part of my time since that offering reviewing, analyzing and assisting in structuring most of our MLPs (also referred to as publicly traded partnerships or PTPs). My firm, Dean Witter, has been involved with MLPs since 1982, initially co-managing the first MLP offering which was made by Apache Corporation in 1982. My statement is presented on behalf of my firm and discusses our experience with publicly traded partnerships.

Dean Witter believes there are several popular -- but inaccurate -- perceptions about MLPs such as they have no economic basis other than to avoid "double taxation" at the entity and individual level. Stated differently, MLPs are "tax avoiders" or "tax loopholes". We disagree. We believe the MLP form provides certain issuers who own certain types of assets with a structure that can increase the value of those assets to its equity owners as a result of this efficient capital raising mechanism. By and large, MLP equity has been used to repay or replace debt. MLPs offer individual investors an attractive equity investment vehicle and therefore afford issuers access to a broad investor group. We believe that the use of MLPs does not result in revenue losses to the Treasury.

My testimony will discuss the marketplace (buyers) for MLP equity securities, the MLP valuation process, the reasons issuers utilize the MLP form, the various financing alternatives considered by our recent MLP issuers, our perceptions of the revenue implications to the Treasury Department of our MLPs and the impact of the Tax Reform Act of 1986 on the use of the MLP and its effect on the marketplace. These are subjects we do not believe the Treasury Department has adequately analyzed or described.[1]

The Marketplace

Since Apache Petroleum first sold MLP units publicly in November 1982, there have been 55 public MLP offerings of note (issue size $40 million or larger) and the aggregate equity monies raised through all MLP offerings (79 issues) has amounted to $6.4 billion of partnership equity. Over this same time period, in the public markets corporations have raised $150.4 billion of corporate common equity through 4,754 offerings, $46.5 billion of preferred stocks and $667.2 billion of long term debt (corporate private equity and debt placements, and commercial paper and bank debt are excluded from these numbers; as well, corporate retention of earnings, which represents the major source of equity for corporate America, is excluded).[2]

1/ DWR, in a letter dated July 16, 1987 to the Treasury Department has commented on Treasury's testimony submitted on the Issue of Master Limited Partnerships to the House of Representatives' Subcommittee on Select Revenue Measures on June 30, 1987 (which is virtually identical to Treasury's testimony filed before this Senate Subcommittee on July 21).

2/ Source: IDD Information Services Inc. (through July 1, 1987) In addition, other tabulations of MLPs may indicate a slightly higher number. Such tabulations would include several corporate conversions (not accompanied by a public offering) and some investment portfolio type partnerships which are the equivalent of a mutual fund and not classified by IDD as an MLP.

Of all these partnership offerings,[3] 62 or 82% are trading at price levels below their original offering prices. If we exclude our oil and gas partnerships, only 38 or 81% are trading below their original offering prices. The average non-weighted yield is 11.2% for all our MLPs (includes only MLPs who have offered securities publicly); for oil and gas MLPs it is 12.0%. Over the same time period, our corporate market equity averages have moved up from 803.27 to almost 2,500 (DJIA) and 108.71 to 312.70 (S&P 500) with indicated current yields approximating 2.9% (5/87) DJIA for these averages. The current average yield for 74 major electric utilities which is an excellent barometer for yield oriented equity securities is 7.9% (6/12/87). Long term Treasury bonds and tax exempt industrial revenue bonds yield approximately 8.5% (30 year Treasury) and 8.0% (15 year revenue bond). Clearly our partnership equity trades at a yield premium to other widely traded public equity and debt investment alternatives. An analysis of partnership equity ownership illustrates that the owners are primarily individuals, contrasted to predominant institutional interest in corporate equity securities. In fact, these MLP securities have been sold predominantly to the individual investor as a fixed income equity type investment with its primary emphasis on current return, with institutional participation reserved for a select few "growth" MLPs. The securities are sold to these investors to be held as intermediate or long term investments, and not as short term trading vehicles.

Our own distribution records support these observations. DWR has participated as a manager in 31 MLP public offerings since 1982 (accounting for $3.5 billion, or 55% of the MLP equity capital raised), selling approximately $1.1 billion of PTP equity through our own branch system almost entirely to individual investors; that is a healthy 39% of all the offerings and approximately 17% of all the equity capital raised in these offerings. We estimate that the average sale for these offerings in our system is about 600 units or $10,122 and the most frequent order size, or the mode, is around 200 units or $3,289. Our experience is that MLP sales and trading in the marketplace are predominantly retail, not institutional. In fact, when you find evidence of institutional ownership with regard to any particular MLP, it more likely is the result of either existing institutional interest related to a conversion from corporate to partnership form or the distribution of units as dividends by a sponsoring corporation to its own shareholders, some of whom are institutional, contrasted to an institutional purchase in a public offering.

The Valuation Process

This reliance on the individual buyer should not be surprising as one notes the evolution of our MLPs and the valuation process applied in our equity markets. While issuers cite numerous reasons for the MLP, such as its usefulness as (1) a valuation vehicle, (2) an efficient equity capital raising tool, (3) a new financial currency, and (4) a form of takeover defense, the reasoning is somewhat circular: the MLP is first and foremost a valuation vehicle, but it does not conform to our classic corporate equity security evaluation model that assumes a dividend yield and an earnings retention which are necessary to provide the bases for growth in earnings and dividends over time. Instead, the MLP valuation is based on full payout of cash flow with minimal provision for retention of cash.

Without providing such valuation in the marketplace, there is no other reason for it to exist. Our oil and gas, timber and agricultural minerals natural resource partnerships most clearly illustrate this fact. Generally, their pretax cash flows have been sufficiently in excess of their corporate after-tax income to provide investors both double digit market yields and tax advantages resulting from the securities that we have designed which effectively prices the assets in the marketplace above that level which the market would capitalize the assets in corporate form. As we have moved away from natural resource partnerships to other industries, the capitalization of cash flow available for distribution on a yield basis has been the critical determinant of value as contrasted to the price/earnings multiple which would have been accorded such issuer in corporate form.

3/ For purpose of price and yield analysis, our sample was adjusted where a) price or yields were not available or b) significant distortions would result as a result of our "unweighted" calculations.

With our natural resource publicly traded partnerships the first and most important factor for the new issue investor has been a high cash yield. In addition, the combination of a tax-free return of capital cash distribution and, a tax loss, has given individual investors an after-tax double digit current yield in many partnerships. These attributes continue to contrast favorably to other taxable and non-taxable publicly trading investment alternatives. However, under the Tax Reform Act of 1986, little or no value is given to any tax attributes in excess of return of capital treatment of cash distributions, and most value is given to pure cash yield, and in cases where pure cash yield exceeds that of government securities, one might expect to find an increase in institutional interest. However, the presence or prospect of unrelated business taxable income (UBTI) and the relative illiquidity of the marketplace has precluded significant institutional interest in cash offerings priced on a current yield basis. As a generalization, institutional investors believe future price appreciation has been priced out of most of our resource partnerships by the retail investor's focus on current yield. This same individual investor had been attracted by those same current yields in addition to the tax benefits, the liquidity of a NYSE traded unit, no minimum investment requirements and the ability to participate through a direct "ground floor" investment with a commodity hedge. Before the advent of the PTP, our individual investor generally did not have the financial ability to participate in partnership offerings. However, to obtain value represented by double digit yields requires distribution of most or all of the partnership's cash flow, imposing a heavy burden on the sponsor in the business entity to reinvest its own distributions or raise additional capital to replace resources. Without a combination of improving/stable finding or asset replacement costs and commodity price increases, value cannot be maintained. Look at the prices of our public oil and gas partnerships over the past two years and note the recent lack of public offerings for this industry.

The previous comments were specifically directed at our resource partnerships, but they provide the foundation of our approach to new industries. If a business entity's pretax cash flow and pretax income are relatively close together and the business historically has retained and needs to retain significant funds to continue its expansion, it will be impossible to produce both maximum value and high yields sufficient to retain the interest of the individual investor, related to other opportunities in the marketplace, as long as his focus remains primarily on current yield; and, since his focus has remained on current yield, it is difficult to avoid full payout partnerships. Consequently, if, heretofore, there has been any institutional interest related to their perception of growth/appreciation associated with this particular business activity such interest will dissipate when the activity is conducted in partnership form because: (1) such institutional investors will not believe growth can continue since such investors feel that management will be pressured by unitholders to retain less cash for growth since unitholders want the maximum amount of cash paid out and they do not want to pay taxes on cash they have not received; (2) the economic value of the switch to partnership form may not be great enough to mitigate the nuisance of filing state tax returns for one or two portfolio investments out of all their other corporate equity investments; and (3) the presence of unrelated business taxable income may force otherwise tax exempt institutions to pay taxes on their investment income, and certain of their accounts may have prohibitions against owning any form of partnership units. In summary, we have significant economic and institutionalized barriers which would restrict the number of potential MLP candidates and effectively limit the participation of major institutional investors.

The Use of the MLP and its Implications for Treasury Revenues

We have experienced a relatively short history in the evolution of our publicly traded partnerships but we can identify four distinct versions:

1) the "rollup",
2) the "rollout" (dropdown or transfer of assets),
3) the "acquisition MLP" (the public buyout, the asset sale, the equity buyout), and
4) the liquidation.

We think it is important to look at each form and understand why the issuer chose this route contrasted to other alternatives available. Once this is understood, one can develop a better understanding of the potential economic effect on Treasury Revenues from these PTPs and a better feel for the continued use of this partnership form.

"Rollups"

The "rollup" started with Apache Petroleum Company's exchange offer which was extended to holders of separate oil and gas limited partnerships previously sold by Apache Corporation in the private market to "high net worth" individual investors; the purpose of this and other rollups was to combine a number of limited partnerships into a larger publicly traded partnership to achieve a "critical mass" providing economic efficiencies, diversification of properties, reduced unitholder risk, a larger borrowing base and partners' liquidity (i.e., greater financial and operating integrity). Since the individual entities are already in partnership form, such a move initially can produce revenues to the Treasury through ITC recapture as the partnerships are reconstituted and, as a larger integral unit, the "rollup" MLP is intended to be more revenue productive than in its separate pieces. Rollups have been more prevalent in the oil and gas industry, which has traditionally used private partnerships to raise capital; currently, we are involved in an exchange offer related to several real estate limited partnerships. In any event, these "rollups" place no new assets into the partnership form. Since its rollup in 1981, Apache Petroleum Company (APC) has come back to the market several times to raise capital for oil and gas exploration and development, and APC has used its units as a financial currency to acquire oil and gas properties from Dow Chemical, Natomas and HNG.

"Rollouts"

In July 1983, Transco Energy Company contributed its domestic oil and gas assets and certain related liabilities into a partnership, Transco Exploration Partners, Ltd. which then sold an 11% minority interest to the public, effecting the first "rollout" of corporate assets into public partnership form (also referred to as a "dropdown" or transfer of assets). The proceeds from the offering were utilized to pay down debt that had been incurred previously for oil and gas exploration and development. The sale of partnership equity was anti-dilutive to Transco Energy's common shareowners contrasted to the sale of common stock (i.e., according to our calculations, Transco's earnings per share were improved slightly, contrasted to a visible and material reduction in earnings per share had Transco sold common stock to raise the same amount of funds). At that time, Transco would not have sold common stock, since its own equity market valuation (about $750 million) was based upon a pipeline price/earnings multiple applied to its pipeline earnings with no apparent value given to the partnership's billion dollar oil and gas reserve position. Indeed, an outright sale of a minority interest in these oil and gas assets to a third party purchaser would not have produced the same value as the MLP. Therefore, the valuation produced by the partnership sale highlighted the value of these assets, allowed Transco to reduce its debt (leading to an improvement in its bond ratings), gave Transco a currency which it could use to enhance its dividend policy and served as a pricing mechanism for its very valuable oil and gas assets. Transco Energy, from time to time, had been subject to takeover rumors prior to the time these assets were placed in partnership form and independently valued in the marketplace; subsequently, partnership units were dividended to Transco shareholders to further enhance their return.

If you looked at the market values of the independent oil and gas companies, or, for that matter, some of the majors at the time of these offerings (1983-1985), you would have seen that market values for these companies' oil and gas reserves were well below the value that could be generated through our MLP yield valuation model. Such explains much of the takeover activity in the oil and gas patch. The histories of El Paso, Northwest Pipeline, Texas Gas, HNG, Getty, Superior, Gulf, ANR, Phillips and Midcon all attest to this. As you know these forced consolidations resulted overall in the shrinking of United States exploration and development efforts in terms of both dollars and manpower.

Several other well known oil and gas companies and a few other natural resource concerns followed Transco's example with minority interest sales of partnership units to the public with the offering proceeds utilized to paydown partnership or sponsor debt. Such rollouts were accompanied by an acceleration of tax revenues through recapture taxes at inception and have increased the probability of increased sponsor income through reduced debt expense and lower levels of depreciable assets to the account of the corporate sponsor. In addition, since the sponsor, generally a corporate entity, has retained a significant interest (in excess of 50%), the corporate tax rate will be applied to its proportion of the partnership's results; on the other hand, the minority interest is generally sold to individuals, who are taxpayers, contrasted to the debt which was retired, which generally had been sold to large institutional investors who probably pay little or no taxes. So we think we have replaced debt with partnership equity and have added a new set of taxable investors and, therefore, have actually increased revenues to the Treasury.

With the decline in oil and gas prices we have seen no new oil and gas rollouts since early 1986. However, our recent nonresource rollouts generally have followed the same path: the sale of a minority interest to the public in MLP form because such sale produces the highest valuation for this particular set of assets and provides the lowest cost of equity financing available contrasted to the issuer's other alternative of raising equity capital through the sale of common stock; in addition, proceeds are generally used to pay down debt. However, in a number of our recent nonresource MLPs, reduction of overall corporate debt has been a corporate necessity. In these MLPs, generally the corporate sponsor needs to raise equity capital to reduce its debt. Sale of common stock was not a viable option because of the immediate dilution to the common shareholders (a corporate sale of common stock is the most expensive source of capital), and, in some extreme cases, as a result of the financial condition of the parent company, there was not a valid market for shares of the common stock to raise the same monies. Restructuring, or adding to, existing debt only serves to compound the financial problem of increased leverage at a time when it is not needed, and, as well, debt capital may not be available (I would remind you that a lender's willingness to lend is based ultimately on his views of a borrower's ability to raise common equity). Retention of earnings at the corporate level is another alternative that is always to be considered, if available. To be more precise - we have dealt with corporate sponsors of varying degrees of financial health. Those sponsors with other choices could leave debt on the balance sheet, could sell common stock or could retain rather than payout earnings; instead the MLP was utilized as a cost effective source of equity capital to meet corporate objectives of debt reduction and establishment of value for undervalued assets (an outright minority interest sale of these assets would not have produced the same value). However, some of our issuers did not have an attractive array of choices: they needed equity, they could not raise debt or sell common stock on financially acceptable terms - the asset they capitalized in MLP form was their best and only choice.

Analysis of most of our nonresource rollouts would illustrate that the corporate sponsor is selling a minority interest of a valued asset, a "crown jewel", and such sponsor retains control and has the predominant interest. Similar to our comments regarding the resource rollouts, we think these MLPs produce more positive revenue results to the Treasury than their corporate alternatives. We do recognize that there have been suggestions about the fixed amount of debt capital available, and that paying down debt just allows it to pop up somewhere else; however, all we see is a continuing growth in debt outstanding in the government, corporate and household sectors. Accordingly, we see the availability of this form of equity financing as an attractive financing alternative, without severe revenue implications to the Treasury.

Liquidations

The actual number of publicly traded companies converting to publicly traded partnership form has been relatively small but quite visible. Newhall Land and Farming Co.'s, Mesa Petroleum Co.'s and NVHomes' conversions in 1985 and 1986 were our three most visible examples until the passage of the Tax Reform Act of 1986. With the repeal of the General Utilities doctrine making it economically impractical to convert from publicly owned corporate form to partnership form after 1986, we saw a rush of conversions at year end 1986 since the new differential in individual and corporate tax rates suggested to these corporate issuers that now was time to escape the double tax burden of the corporate form; liquidation did mean disincorporation. Our records indicate that four attempts were made to convert but only three received the requisite shareholder approval. Community Psychiatric Centers failed to win the requisite shareholder approval for its plan to convert to a publicly traded limited partnership; in this case, institutional investors owned slightly over 50% of Community Psych's stock. We suspect that with the repeal of General Utilities doctrine, the imposition of a tax at both the corporate and shareholder level in the event of a conversion has eliminated, for all practical purposes, this form of MLP.

Acquisition MLPs

Our most recent versions of the MLP, which reflect an extension of our rollout MLPs, are the most difficult to understand from an outsider's point of view. These new MLPs have also been referred to as "equity buyouts", "asset sales", and "public buyouts"; and when we review some proposals by corporations to sell their unwanted asset, we refer to them as "exit" sales. To better describe these "acquisition MLPs", we think they can be divided into three groups (1) "public buyouts", (2) the "asset sale" and (3) the "blind (semi-blind) pool" MLP.

The public buyout (PBO) can be characterized as a public leveraged buyout capitalized with a ± 50% debt ratio with debt sold to institutional investors in the private marketplace and equity (±50% equity ratio) sold in the public marketplace primarily to individuals. The intent of the seller is to sell an operating entity (which generally has been a division or subsidiary of a publicly traded corporation) at the highest price available. This seller has looked at alternatives such as a third party sale to another corporation, a sale to the public in corporate form, an internal restructuring encumbering these assets with a significant level of debt, a leveraged buyout and our PBO. This general ordering of alternatives is intended to illustrate the increasing valuation and proceeds to the seller as he moves down the analytical path from third party sale...to the PBO. While the market has seen the surge in LBOs, again based on the pursuit of the highest dollar by the seller, only recently have some sellers bypassed the LBO to utilize the PBO. As you know, characteristically, the leveraged buyout has been capitalized with a greater than 90% debt ratio, and, therefore, less than 10% equity, with both debt and equity sold in the private marketplace to "institutional" investors who are low or non-taxpayers. Some observations: with our PBOs, the initial sale provides at inception a higher taxable valuation than the seller's corporate alternatives and these MLPs will operate with lower levels of debt and with a greater dependence on a taxable investor group, the individual investor; accordingly, the revenue impact of eliminating this financing mechanism would probably result in the selection of alternatives designed to produce less revenues to the Treasury. In addition, from a practical point of view, given that this type of offering represents an "exit sale" with the desired objective of selling 100% of the equity to the public, we believe that without the availability of institutional investor backing, the number and size of possible transactions is limited. And, speaking of investment attributes, how many times have you seen a corporation voluntarily selling 100% of its "crown jewels"?

The asset sale represents the outright sale of a defined set of assets to the public (which may/may not be burdened with debt) in MLP form and, primarily, has consisted of sales of real property contrasted to utilization of its corporate counterpart, the REIT (real estate investment trust), another pass through vehicle. Generally the selection process involves consideration of the nature of the assets, optimizing current sale proceeds, the degree of operating flexibility the sponsor needs or desires, and the ability of the sponsor as GP in MLP form to share in future results. What is the effect on Treasury revenues? This is harder to quantify: both entities pay out all free cash flow to owners. Consider that: (1) the REIT does not generate UBTI and therefore is owned by institutions and individuals (taxpayers and non-taxpayers); the MLP is owned primarily by individuals (taxpayers); (2) in MLP form, the more successful the results of the business entity, the more likely the GP receives a "backin" (or interest in profits) which ultimately is taxable at the sponsor's (corporate) tax rates; and (3) the flexibility of the MLP form suggests a better chance for growth. We think the market has yet to settle this debate, but it does not appear, currently, that we are dealing with a revenue loss/gain question but perhaps, instead, some opponents/proponents of MLPs/REITS are getting bogged down with insular positions. Our own position relates to raising the maximum amount of equity capital in the most efficient manner.

Our experience with a recent REIT offering would suggest to us that the REIT may be better suited for passive type real property investments, either on a diversified property or dedicated property basis, and that the real property

MLP is better suited for operating assets that need to be actively managed as an ongoing business. In January, we lead managed a $200 million offering for American Health Properties, Inc.; this is the third largest REIT offering completed in the eighties (1980-1987). We looked very carefully at the MLP/REIT equity alternatives. We advised American Medical International, Inc. (AMI) to proceed with a REIT offering because: (1) the assets of the proposed business entity were hospital facilities (dedicated properties) which were to be leased to AMI subsidiaries and, essentially, represented a passive property investment; (2) our objective was to maximize the issue size; to accomplish this objective, we needed institutional investors who we believed would be unavailable in sufficient size if the issue was structured in MLP form; and (3) while rentals based on gross revenues do not create UBTI in a partnership, utilization of debt to acquire properties would produce UBTI related to revenues derived from such properties and we knew the company intended to make additional investments in other health care-related facilities utilizing debt, as necessary. Accordingly, our decision was based upon the operational aspects of the properties, the intentions of management and the investment classification of the results (portfolio income vs. UBTI) in the hands of institutional investors.

The third new entry is the blind (semi-blind) pool MLP (some or all of the proposed partnership properties or securities holdings are not specified at inception). This structure is more typical of a real property or portfolio type partnership whose practical counterpart would be the REIT or mutual fund. With the exception of the remarks made above, we have not seen enough of these competing structures to have an opinion as to which structure is most manageable, marketable, or cost effective. In all cases, the intent is to raise capital. What are the tax effects? Unless the sponsors (actual issuer or syndicator) are touting their selection of the MLP form as providing passive income to offset passive loss from some new or old partnerships, I have a hard time posturing anything but revenue neutrality from Treasury's perspective. While we have not been active in either real property "asset sale" or "blind pool" MLPs, we have never "sought a trade", structured a deal, or sold a deal based upon the concept of passive income as defined under the new code...and we certainly will not given the possibility of a change in definitions in the future.

We would ask that you carefully consider the revenue implications of our public partnership offerings. We do not have revenue forecasts. We only can recount our experience with our issuers on a case by case basis. Since the MLP is so new a financing structure we would hope you would take the same approach, contrasted to a knee jerk reaction to anything bearing the name, MLP. We think our "rollups" and "rollouts" have, by and large, accelerated tax revenues through recapture taxes at inception and have increased sponsor taxable income through reduced debt expense and lower levels of depreciable assets at the sponsor level. On the other hand, our asset sales and PBOs generally have provided at inception a higher taxable valuation than their corporate counterparts, the REIT and leveraged buyout, and these PTPs will operate with lower levels of debt and with a greater dependence on a taxable investor group, the individual investor (Indeed, all MLP equity investors, individual, institutional or foreign, cannot avoid one level of tax imposed on partnership income). Our point: the corporate alternative to these new MLP structures, by and large, probably would produce less revenues to the Treasury than these MLPs.

The 1986 Act and the MLP

Understanding who is the market, the construction of the partnership vehicle, and the uses to which the MLP is being put is necessary to reach any meaningful conclusions as to the effect of the Tax Act of 1986 on MLPs. The market is primarily retail and its requirement has been for current income which forces a partnership structure emphasizing full payout of cash with little or no value given to the potential for tax losses by our general individual investor group, particularly as a result of the 1986 Act. Such structure, to produce value, restricts the number of eligible targets to those with minimal capital expenditures and only those entities that can produce growth without capital expenditures have a chance of attracting institutional investors; nonetheless, institutionalized barriers such as the impact of UBTI on such institutions and the nuisance of filing state income tax reports will keep their participation low even were the MLP to meet their investment growth requirements. These MLP structures can not employ a heavy degree of leverage since any fluctuation in revenues has an immediate impact on per unit cash distributions. The market to date, which has not produced the best results to the buyers, is policing itself - i.e., your can not keep selling MLPs that trade down. MLPs are sold to produce value and we think their revenue implications are more positive to Treasury than their corporate counterparts. With this in mind, I would suggest that the Tax Reform Act of 1986 through its extension of the "at risk rules", the provision that passive income may only offset passive losses of other partnerships, and the repeal of the General Utilities doctrine, closing the "loophole" related to a corporate to partnership restructuring along with new partner reporting requirements have gone a long way to reduce any concerns of a mass exodus from corporate to partnership form and to the threat of increased revenue loss contrasted to what these issuers would have done without the MLP.

As you know, corporations employ a fairly heavy utilization of debt which, by and large, is sold to tax exempt institutions and such corporations practice an indefinite retention of corporate profits through low dividend payout policies in order to maintain their business endeavors and reduce taxation. Our MLP offerings generally have provided the highest achievable valuation for the business or assets being sold. The use of proceeds of our partnership offerings have been utilized primarily to pay down debt (whether it be partnership or the sponsor's debt) or pay top dollar value for the sale of designated assets, our MLP capital structures have been debt adverse (contrasted to what they would have been in corporate form - even our "public buyouts" are capitalized with less debt than their corporate cousins, the leveraged buyout) and, generally, full payout is made to investors who are taxpayers, that is, individuals (In fact, all partnership income allocated to MLP investors, whether they be individuals, foreigners, tax-exempt institutions or corporations, is subject to one level of tax).

Administrative Considerations

Aside from tax revenue concerns we understand the Treasury's (IRS) concern for tax compliance on both the part of the partnership and its partners. Indeed tax compliance is more complex due to the need to comply with Partnership Taxation rules concerning the ultimate determination of tax liability, the need to breakdown overall consequences to the individual limited partner level, and the reporting necessary to allow the MLP to prepare K-1's for each of its unitholders. I think it is important to understand that when issuers, lawyers, accountants and bankers structure and offer publicly an MLP, we are operating in a "fish bowl". Our issuers are generally well known, and the lawyers, accountants and bankers are highly visible with reputations for expertise in this field. Our prospectuses are available for full public review; they contain the business description, the financial description, and the partnership agreements and reflect the conclusions of our legal and accounting experts on the application of partnership law and the tax code. Assumptions are made on the conservative side, and these experts are always available to discuss their views with the Treasury. These vehicles are not set up to take aggressive tax positions.

As a business entity, the MLP utilizes an organizational form that permits the results of operations, including tax benefits, if any, to flow through directly to the source of capital, that is, to the investor, whether that source be debt, preferred or "common unit"; any tax benefits that flow through to the investor merely reflect those incentives or other provisions that were legislated for the express purpose of fostering expansion and development of that business endeavor regardless of business form. Our MLPs have been formed for valid business purposes. Access to a new set of investors for long term equity capital has provided more benefit to our issuers than any other debt or equity alternative under consideration. In some cases, the MLP route represented the only practical source of capital (debt or equity). With the exception of corporate to partnership conversions, tax avoidance is not the driving force. In addition, we have not been involved in any transaction, and are unaware of any proposed transaction which was or will be precipitated as a result of the change in individual and corporate tax rates pursuant to the 1986 Act.

We do recognize that tax compliance is more complex due to the need to break down overall tax consequences to the individual limited partner level. However, many of the major Big-8 accounting firms have spent much time perfecting accounting software to break down items of income, loss, gain, deduction, and credit per individual partner. Their assumptions tend to be on the conservative side and while some problems remain, probably the biggest, "Street" name holdings, which sometimes has precluded preparation of totally personalized K-1s, will disappear as a function of legislation and our efforts. Specifically, major brokerage firms will comply with reporting requirements in order to get the names of the real holders of MLP units to the General Partners of these partnerships. Dean Witter can provide on a current basis names of the owners to MLPs but such a "data dump" is not really particularly useful without building a better history of the holder for the MLP. While the Treasury has not yet finally prescribed the exact information requirements and the form of such information, currently, our in-house programming staff is working with our operations people to write programs to provide more meaningful information for the MLPs. We are working under contract with Independent Election Corporation of America (IECA) who will act as collection agent interfacing with brokers, banks and other nominees nationwide to collect and consolidate the nominee information, and certify nominee compliance with Section 6031. IECA and Wall Street Concepts, (another independent consulting firm which had been conducting a pilot program at the request of the Technical Tax Committee of the Securities Industry Association in order to develop a "Street Names" Partners Report) announced on June 12 their agreement to jointly provide nominee services to the MLP community. Under the agreement Wall Street Concepts (WSC) will act as the servicing agent for the MLP issuers. WSC has proposed to provide MLPs with the Street Name Partners Report, a hard copy and tape service, which provides MLPs with nominee data in the format usable by their partnership unit accounting systems. The point - we want to comply and we will.

Summary

Where does that leave us? As a result of structuring and selling PTPs to the public we would suggest that:

(1) MLPs will be sold primarily to the individual investor as a high yield fixed income equity type investment with the primary emphasis on cash; the "market" is paying for current cash and not tax loss; and these MLP investments are intended as intermediate or long term investments and not as short term trading vehicles;

(2) the MLP as an investment vehicle has widened an issuer's access to a broader investor group which previously could not participate in most partnerships as a result of high net worth and income requirements;

(3) the valuation process and resulting MLP financial structure requires that the capital structures of MLPs will need to be more conservative (i.e., less debt) than their corporate counterparts and the cash payouts to owners well in excess of such counterparts;

(4) the pricing and structure of the MLP suggest institutional interest will remain minimal, further restricting the marketability for issues and the number and size of issues since loss of access to institutional equity serves as a major deterrent to a widespread use of MLPs;

(5) the yield evaluation model is extremely efficient for those entities that fit but the implications of any valuation model emphasizing maximum cash payout to individual investors would suggest that there are not that many eligible candidates;

(6) our MLPs have been formed for valid business purposes; access to a new set of investors for long term equity has afforded more economic benefits to our issuers than any other debt or equity alternatives under consideration, and, in some cases, the MLP equity route represented the only prudent or possible source of capital (debt or equity);

(7) other than the rush of a few publicly traded corporations prior to year end 1986 to complete corporate to partnership conversions,

thereby avoiding the implications of the repeal of the General Utilities doctrine, the use of the MLP has not been accelerated by the 1986 Act;

(8) while partnership tax issues are complicated, our MLP issuers operate in full view of the public, utilizing accounting, tax, legal and banking experts, emphasizing full disclosure in their public documents (prospectuses, partnership agreements, quarterly and annual reports), and practicing conservatism when dealing with questions of partnership law and taxes;

(9) Wall Street recognizes the added difficulty with regard to MLP tax reporting; we are working to cure this "problem" and will work to solve any other problem the Treasury or Internal Revenue Service may raise, and the MLP, as any new financing technique, may have wrinkles that need to be worked out but we will work them out;

(10) in addition, while the Tax Reform Act of 1986 has shrunk the market of eligible candidates and has removed potential abuses, you can count on the fact that the marketplace, through daily price moves, will tend to wring out any other candidates unfit for the partnership form; with over 80% of our new issues trading below their initial offering prices, the marketplace can not continue to absorb MLP issues that trade down rather than up; and

(11) for those concerned with revenue loss, the corporate alternatives to our recent MLP versions should be of greater concern to you than our MLPs; furthermore, without the availability of the MLP, prospective issuers may resort to additional debt, greater retention of earnings, or cancellation of projects rather than proceeding with a sale of their most costly equity security, common stock; in addition, all MLP investors, individuals or institutional, are subject to one level of tax on partnership income. Consequently, we think our MLPs have been revenue effective, on balance, and have not eroded the Treasury's revenue base contrasted to the other alternatives available to these issuers.

Accordingly, we do believe, through the MLP, we are utilizing a cost effective equity vehicle which produces a higher value for the issuer's underlying assets than is currently available in the marketplace, and we are very concerned about attempts to destroy this financing mechanism. We are pleased to be able to address you today about our experience with MLPs and we would be pleased to spend as much time as you need to assist in a better understanding of our approach and our view on the appropriate use of this financing vehicle.

Statement of

Myles H. Tanenbaum
Chairman and Chief Executive Officer
EQK Partners

Before The

Subcommittee On Taxation and Debt Management

Finance Committee

United States Senate

July 21, 1987

Mr. Chairman and Members of the Subcommittee:

My name is Myles H. Tanenbaum and my testimony is submitted in behalf of EQK Partners, and two limited partnerships sponsored by EQK Partners for which it acts as adviser: EQK Green Acres, L.P., which owns a super-regional shopping mall whose units are listed on the New York Stock Exchange, and EQK Shopping Malls, L.P. which has contracted to acquire four regional shopping malls and last week filed a Registration Statement with the S.E.C.

EQK Partners is a joint venture between The Equitable Life Assurance Society of the United States, and my partners and I who own Kravco Company (the nation's fifth largest developer and manager of shopping malls). EQK Partners has pioneered the securitization of real estate equities, having been formed in 1983. Its first effort was a real estate investment trust (EQK Realty Investors I) which introduced the concept of a fully-specified, closed-end, finite life equity real estate investment product.

My testimony deals with investment grade rental real estate owned by limited partnerships whose shares are freely tradeable, thereby affording liquidity to the partners.

The premise which underlies this testimony is that liquidity, as an incident to real estate investment, affords a significant socio-economic advantage. Liquidity enables ownership interests in real estate to be transferred in a manner similar to publicly traded stocks and bonds.

Such liquidity means (a) the price "assigned" to a real estate partnership interest would be the product of the market forces of supply and demand, under the "microscope" of the full disclosure required by the securities laws; (b) partnership share offerings burdened by uneconomic charges will be foreclosed by reason of broad market disclosures and the competitive forces of daily trading; (c) capital committed to real estate investments can be readily converted to alternative uses or investment and is not locked out of such other opportunities; and (d) the opportunity to participate in real estate investment will be afforded to the full range of investors, including the "small investor," by reason of the lower threshold minimum investment.

Summary of Comments and Recommendations:

- Imposing corporate tax treatment on publicly traded limited partnerships ("MLPs") owning rental real estate will produce no increase in tax revenue because such legislation would simply put an end to MLP ownership of such real estate: given the choice between liquidity with the added cost of corporate taxation and single-tiered taxation, via illiquid partnerships or individual ownership, the time-honored non-tradeable format will always be selected.

- Holding rental real estate in MLPs will generate more tax revenue than would be the case if the real estate were owned either by limited partnerships that do not trade or by traditional real estate investors, namely pension funds, foreign investors, insurance companies and wealthy individuals.

- Without MLPs, the "small investor" would once again be foreclosed from "investment grade" real estate opportunities and be relegated to such rental real estate investments as would be available via non-tradeable limited partnerships. In addition, such investments would be burdened by the higher fees and other charges associated with non-trading offerings, erasing the progress recently made in reducing such costs by reason of the competition afforded by the publicly traded limited partnerships which are judged daily in the harsh truth of the securities market auctions.

- Real estate investment trusts ("REITs") do not meet the competitive challenge of the partnership structure and they also suffer from certain legislative burdens which make REITs less desirable structures from the standpoint of the sponsor and the investor.

- Our testimony in favor of continuing partnership tax treatment for publicly traded rental real estate investments should not be construed as advocating that other MLPs should be subject to two-tier taxation. Rather, our remarks are intended only to demonstrate the reasons rental real estate MLPs should continue to be afforded partnership status notwithstanding that they are publicly traded.

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A. Rental Real Estate Investments--- Background and Relevance.

1. Size of the Market. Estimates concerning the aggregate dollar amount of commercial rental real estate range upward of $1.5 trillion, net of related mortgage indebtedness. That amount compares surprisingly well with the value of all common stock equities, estimated to be $3 trillion. Whereas common stock equities trade freely, virtually all rental real estate has been closely held and does not afford investors the liquidity associated with securities.

2. What it Takes to Own Investment Grade Rental Real Estate. Virtually all of the investment grade rental real estate in the United States is owned by the people who developed or currently use the properties, or by pension funds, insurance companies, foreign investors and wealthy individuals. A small portion of such real estate is held by real estate investment trusts ("REITs") and non-tradeable "public" limited partnerships -- but, for the most part, the quality of the properties held by the REITs and public partnerships is below what knowledgeable investors classify as "investment grade." Consequently, until recently, so-called small investors have not had the opportunity to access investment grade real estate. By contrast, such investors have had, and will continue to have, the opportunity to invest in the common stock of virtually every blue chip company in the nation -- and that is because such stocks trade daily on the capital markets. "Securitization," in time, will afford a similar opportunity with regard to equity real estate, provided tax legislation does not inhibit such real estate investments from being offered in "pass-through" entities (i.e., does not deny the tax and investment attributes otherwise available to major investors).

B. Rental Real Estate Investments Have Traditionally Avoided a Two-Tier Level of Taxation.

1. Individual, Partnership and Tax-Exempt Ownerships. As noted above, the ownership of rental real estate has traditionally been in a format which precludes an entity level tax, and increased real estate investment by pension funds over the past two decades has eliminated taxation for properties acquired by such parties. Tax advisers have studiously steered their clients from corporate ownership because it would create an added level of taxation. To be sure, corporate ownership always represented a simple and convenient mode, but it entailed an added tax cost which found no economic justification. Investors having the opportunity to participate in real estate investment via a "pass-through" (partnership) tax structure will be the "marginal" buyers who effectively set the competitive price/yield for the acquisition of properties. "Pass-through" without an MLP will always be available to major investors. The small investor could invest with a "pass-through" structure only via REITs and non-tradeable limited

partnerships, both of which have serious investment limitations for reasons discussed in subsequent sections of this statement.

2. Real Estate Investment Trusts ("REITs"). During the past quarter of a century that real estate investment trusts have been authorized by Congress, the liquidity option was afforded to real estate investors without the "price" of a second tier of taxation or an MLP structure. REITs, however, have occupied only a minor position in regard to real estate investment, perhaps because REITs do not feature portfolios with "investment grade" properties. The REIT legislative rules are so restrictive as to render REITs less competitive in acquiring quality real estate, thereby making REITs a far less desirable form of ownership than limited partnerships, whether non-trading or MLPs. Among the more significant concerns relating to REITs are the following:

(a) Regrettably, it seems inevitable that legislatively created entities have intricate, multiple tests or requirements. In the case of a REIT, there is the organizational test, the income test, the asset test and the distributional requirement. Each of these present problems that constrain entrepreneurs. It is not simply the fact of regulation. Rather it is the complexity and its concomitant, namely, the opportunity to trip on a technical non-compliance, which makes one more than a little bit cautious. Our organization did bring to market a REIT (EQK Realty Investors I) and in the course of doing so and by reason of the aftermath of its operation, we learned by first-hand experience the discomfort of these hurdles. We must avoid "bad" income; we must observe "safe harbor" rules regarding sales; we must render certain services through "independent" contractors; we do not provide our investors the equivalent tax features available to partnership investors; and, sadly, there are even more technical pitfalls.

(b) But, from the standpoint of the sponsor of a REIT, perhaps the most serious obstacle is one which might otherwise seem innocuous. I refer to the requirement that the five largest shareholders may not own 50% or more of the outstanding shares at any time during the last half of the year. Why is this so serious? The answer, quite simply, is that providing the opportunity to acquire "investment grade" real estate at its fair market price inevitably will attract the acquisitive desires of those who have been the dominating parties in the acquisition of investment grade real estate. Those parties are driven by self-interest to ferret out whatever prime properties are available for acquisition and to make every effort to purchase them. Consequently, a real estate investment trust owning desirable ("investment grade") real estate will sooner or later become a "take-over" target. In the case of a REIT, a move on the shares could result in elimination of the REIT status, leading inevitably to liquidation. A sponsor would not want to undertake the enormous burden of bringing a REIT to market with "investment grade" properties only to witness the demise of the REIT via acquisition of "too large" a share by a "competitor."

(c) While there are a number of tax features of real estate ownership available to individuals and partnerships which are denied to REIT investors, perhaps the most significant has to do with the taxation of distributions and such taxation has a bearing on REIT investment practices. To illustrate, the determination of taxable income to all entities owning real estate is made at the entity level; in the case of an individual owner, the receipt of cash flow as such has no tax relevance; in the case of a partnership that is likewise the case, qualified only by the tax basis rules which involve complexities beyond the scope of this testimony; but, in the case of a REIT, because the investor is not attributed with a pro-rata share of non-recourse debt, distributions representing return of capital at the REIT level that are in excess of basis in the REIT shares would "create" taxable income. Probably for that reason REIT sponsors, for the most part, have not followed investment practices designed to produce such distributions. The consequence is to deny the REIT investing public the comparable investment result achieved by individual and partnership investors, and without the opportunity to produce like benefits the REIT has failed to become a competitive bidder in the pursuit of investment grade real estate as discussed below.

C. Competition -- The Ultimate and Inevitable Test.

1. Competition in the Acquisition of Real Estate. "Investment grade" rental real estate is purchased for the purpose of obtaining the investment yield that can be produced by the property. Unlike a position in corporate management, there is no power or prestige attributable to ownership of real estate except to the extent that the investment itself provides a satisfactory or even better investment result. Consequently, real estate acquisition, for the most part, is a "numbers game" undertaken to achieve the ultimate objective of a minimally acceptable yield. In that light, it should be obvious that differentials among potential buyers with regard to benefits and burdens will make one party more competitive than the others -- such differentials involving taxes, administrative costs, operational freedom, financing, etc. generally will inure to the benefit of the party having greater flexibility, less regulation and a more favorable tax structure. Generally, that equates with a partnership format and, as discussed in the preceding section, such shortcomings have hampered REITs. And it follows that an entity regarded for tax purposes as a corporation cannot be competitive when it comes to acquiring the properties sought by the major investors, specifically investment grade real estate.

2. Competition Via Liquidity -- Is it Worth the Price? Without question, liquidity has a price. It is not inexpensive to undertake a public offering and to meet the related somewhat burdensome reporting requirements. If the value added by liquidity is equal to or greater than the related cost, a publicly traded entity certainly would offer a competitive investment product. But the "measurable" advantage of liquidity is not such that it can also sustain the added more significant "cost" of a double level of taxation.

3. Liquidity at the Price of Corporate Taxation. Liquidity for real estate investment is a product of the joint conviction of an entrepreneur and a securities firm that "the market" will accept a proposed price/yield structure for a real estate product. Is it

realistic to presume that an entrepreneur would make the substantial investment needed to bring such a product to market if it would be offered at a price/yield competitive disadvantage to non-tradeable real estate investment? If such an entrepreneur surfaced, is it at all likely that a securities firm would agree to undertake such an offering? The answer to both questions, without equivocation, is "NO." The overwhelming likelihood is that either the entrepreneur, the underwriter or both will be deterred by the recognition that the knowledgeable investor would not be likely to choose liquidity at the price of a significantly reduced investment yield attributable to double taxation.

D. Tax Revenues -- The Impact of Double Taxation.

1. MLPs Subject to Corporate Tax Treatment. For reasons expressed above, imposing corporate tax treatment on MLPs owning rental real estate will simply put an end to MLP ownership of such real estate. Consequently, a corporate tax imposed on MLPs will equate with no added tax revenue.

2. MLPs Recognized as Partnerships. By their very design, MLPs provide the equivalence of having the underlying real estate trade freely. With liquidity, the frequency and dollar volume of turnover of such real estate is increased dramatically in contrast with the virtual absence of turnover of non-trading limited partnership interests. Trading, obviously, produces a concomitant increase in taxable transactions which could lead to added tax revenues. For example, during the first year following its listing on the New York Stock Exchange, trading activity in the shares of EQK Green Acres, L.P., for which EQK Partners serves as adviser, will aggregate a bit over 30% of its total shares. In contrast, there had been no sales at all during the preceding 9 1/2 years when Green Acres Mall was owned by the predecessor non-trading partnership. Such an increase in real estate transactions will produce tax recognition and hence potential tax revenue, and such revenue would be generated solely by reason of the liquidity provided by MLPs.

E. Public Policy -- Liquidity is The Touchstone to Investment Opportunity.

1. Who Needs Liquidity? Real estate investments have traditionally been closely-held, whether by outright ownership or via joint ventures with limited participants. Many of those who have been successful in a non-liquid format and see MLP sponsors only as new competitors may well look at liquidity as an unwelcome idea, subscribing to the notion that "if it ain't broke, why fix it." And why not? Participants in a marketplace with relatively few players would certainly not be anxious to see increased competition for obvious reasons. But a market restricted to a limited number of large players is not healthy in a democratic society. Denying public trading equates with reduced participation by the "small investor" and no sound argument can be made in support of such a position. It would seem particularly indefensible for reduced small investor participation to be attributable to tax legislation which has no prospect of generating revenue.

2. Non-trading Limited Partnerships -- The Alternative to MLPs. Were there to be corporate taxation of MLPs, thereby leaving non-trading limited partnerships as the logical alternative, should this be a cause for concern? We think so. Because the pricing and economic validity of investments couched in non-trading limited partnerships are not tested against the daily auction in the securities marketplace, there is no market mechanism to control the avarice of the promoter/distributer in the selection of real estate or the imposition of charges. Indeed, the quality of the real estate which has been included in such limited partnerships, and the fees and other charges related to such offerings, have been questionable, at best. It is noteworthy that fees associated with such offerings have dropped sharply only during the past few years when the fees related to securitized real estate offerings -- which are tested by their impact on yields and daily market quotations -- have provided a stark counter-point to those which burden the illiquid limited partnerships, the investment alternative for the small investor. In that light, the issue once again must be phrased in terms of questioning the justification for Congress enacting a non-revenue generating tax law that inhibits broad market participation in "investment grade" rental real estate and permits illiquid offerings to dodge the market test of reasonableness.

F. Rule Changes -- The Task of Drawing Lines and Creating Transitional Relief.

1. The Search For Tax Revenues -- Distinctions Should be Drawn. While there is an obvious concern that loopholes in the tax laws could create a loss of needed tax revenue, common sense and sound judgment should govern every attempt at loophole plugging. To be sure, it is far from clear that MLPs present a threat of serious revenue erosion. More to the point, however, taxing MLPs which own rental real estate as corporations will not plug any loopholes and may very well lead to a loss of tax revenue for the reasons noted. Congress is accustomed to drawing fine lines, and does so frequently when drafting tax legislation. If there is a perceived need to prevent a potential loss of tax revenue by taxing MLPs as corporations, for the reasons outlined MLPs owning rental real estate should be excepted and permitted to retain partnership status.

2. Transitional Rules -- The Essence of Sound Governance. Publicly traded limited partnerships are clearly taxable as partnerships under existing law. If the law were to change, it is hard to conceive that Congress would make such a change applicable to MLPs now in operation or in an advanced stage of formation. With respect to the former, such legislation would overnight remove 34% of the net income and presumably a similar share of the market price of such securities. Such a "removal" would occur right before the very eyes of your taxpayer constituents who presumably had exercised sound judgment in making their investment commitments. To remove 34% of an individual's savings should be supported by a compelling need. That is not the case in this instance. It certainly would raise serious doubts within the investment community in that legislation of this sort could be -- more appropriately, should be --

made prospective only. A "retroactive" application would be essentially confiscatory and consequently would spawn serious doubts and concerns with regard to the mindset of a Congress unwilling to stand behind clearly implied promises of essential fairness in all legislation.

3. Commercial Activities Are Always Based on Existing Law -- Retroactivity is Anathema. An undertaking to assemble real estate for a public offering via a limited partnership is a rather long, arduous and expensive effort. With regard to the proposed offering of EQK Shopping Malls, L.P., sponsored by our company, the costs to date have reached the $1 million level and we have only now reached the stage of filing our Registration Statement with the S.E.C. Should any legislation be proposed with regard to taxing MLPs as corporations -- irrespective of whether such legislation is ultimately adopted -- the impact would be an immediate death knell to the offering. Because the period during which the real estate in question is under contract (October 31, 1987) will terminate before the legislative issue is resolved, our concern relates to the introduction of such legislation following these hearings. Unfortunately, the possibility of such legislation has already created a cloud on the offering. Hopefully that cloud can be removed by a prompt and forthright statement to the effect that any rule change would be prospective only, accompanied by a set of transitional rules that would safeguard those undertakings already in the pipeline.

* * * * * * * * * *

Conclusion:

An important theme embodied in last year's Tax Reform Act was the need and desirability to "neutralize" the impact of tax legislation on business and investment activity. We so frequently heard expressed the virtue of enabling all taxpayers to play "on a level field." The issue facing this Subcommittee, insofar as it applies to opportunities for the small investor to acquire "investment grade" real estate, essentially is a challenge to the willingness of Congress to hold to that principle.

Tax legislation which places a second-tier of tax on those MLPs which afford rental real estate investment to investors will foreclose such an opportunity; no tax revenue will be gained by such an enactment and it is likely corporate taxation will actually reduce tax revenue; and the "small investor" will be relegated to the non-trading limited partnership offerings with their traditionally higher fees and their penalizing resale price when an investor wants to cash out prior to complete liquidation.

How can such a result be justified? It cannot! MLPs that own rental real estate should continue to be regarded as partnerships for Federal income tax purposes.

MHT/dmb
July 21, 1987

STATEMENT OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
ON
MASTER LIMITED PARTNERSHIPS

INTRODUCTION

My name is Wallace R. Woodbury. I am Chairman of the Board of Woodbury Corporation, Salt Lake City, Utah, a long-established real estate development, brokerage, management and consulting firm. I am also Chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I submit this testimony today on behalf of the members of ICSC.

The International Council of Shopping Centers (ICSC) is the trade association for the shopping center industry with over 21,000 members. Membership includes developers, owners, retailers, lenders and all others having a professional interest in the shopping center industry. ICSC members represent most of the 28,500 shopping centers in the United States. In 1986 these centers generated $20.3 billion in sales tax revenues and employed 6.9 million people.

The hearings concerning master limited partnerships are of particular interest to ICSC. Limited partnerships are the traditional entity employed for financing real estate transactions. Changes in the manner in which limited partnerships are taxed would have profound consequences for members of our organization.

ICSC supports the current system of taxation applicable to MLPs and limited partnerships. To the extent that Congress determines that special tax rules should apply to MLPs or other "pass-through" entities, we would strongly urge that a special exception to those rules be granted to real estate. The exception for real estate MLPs can be justified by the fact that investments in real estate have traditionally been made through limited partnerships and that such entities are not "disincorporating" to take advantage of the tax rate structure following the Tax Reform Act of 1986 ("TRA '86").

STATEMENT

1. Limited Partnerships and Real Estate

Limited partnerships have traditionally been used as the investment vehicle for real estate transactions. The principal advantage to the limited partnership is the flexibility it offers to investors. Some investors desire cash flow while other investors prefer investment appreciation. Special allocations, within the limitations of Code §704(b), permit investors to structure real estate investments to reflect economic realities.

Real estate MLPs have recently become popular investment vehicles. In contrast to pre-tax reform real estate tax shelter investments, these MLPs offer investors cash flow and high yields as opposed to deductions and losses. Tax-oriented limited partnership investments have been curtailed by extended depreciation periods, and the passive income and investment income rules of TRA '86. Congress has succeeded in forcing partnerships to highlight the economic as opposed to the tax advantages of real estate investments. Real estate MLPs permit partnerships to retire debt and acquire property on a less leveraged basis.

The Treasury and a few other commentators have proposed that Congress tax MLPs as corporations. The principal justification for this tax treatment is that unless MLPs are taxed as corporations, significant amounts of revenue will be lost as corporations disincorporate and switch to the partnership form of business. This rationale would not apply to real estate MLPs.

The real estate industry should not be compared with businesses that disincorporate and form MLPs to avoid double taxation. The real estate industry is not avoiding taxes through the use of MLPs and contributing to the erosion of the corporate tax base. Real estate investments were conducted through limited partnerships before tax reform and continue to be conducted as limited partnerships after tax reform.

In addition, taxing real estate MLPs as corporations would have a substantial negative effect on the real estate industry. Yields on real estate MLPs would be significantly lower due to the tax. Investors would have little incentive to invest in real estate. Further changes to the partnership tax rules are unnecessary and may have the unintended consequence of reducing capital investment in the United States. Real estate transactions would again become increasingly leveraged as the ability to raise equity capital from a large number of investors would be curtailed.

In the event Congress decides to tax MLPs as corporations, a special exemption should be granted to entities involved in real estate. These activities have traditionally been conducted in noncorporate form. Alternatively, only those limited partnerships listed on a public exchange should be taxed as corporations. Taxing all MLPs as corporations would economically cripple many legitimate publicly issued partnerships.

The proposal that partnerships allocate tax losses only to those partners with unlimited liability ignores the economic effect of a partnership's losses on the value of a limited partner's interest. As long as loss allocations have substantial economic effect (as set forth in code 704(b) and the regulations thereunder) limited partnerships should be permitted to allocate losses to limited partners. The loss of capital on the part of a limited partner surely qualifies as bearing the risk of economic loss in a partnership investment.

2. Passive Loss Rules and MLPs

The passive loss rules were enacted in TRA '86 to encourage taxpayers to make investment decisions based on economic merit rather than for tax considerations. Real estate MLPs are designed to provide investors with cash flow and high yields, not primarily with tax benefits. Treasury has expressed concern, however, that income from MLPs may be used by taxpayers to offset passive losses. Since real estate MLPs are not formed to avoid the passive loss rules, the issue of whether MLP income is passive involves tax policy considerations other than the proper classification of MLPs for tax purposes.

Concern that real estate MLPs may eviscerate the passive loss rules is unfounded. As the cash flow from most MLPs offer investors an 8-10% cash-on-cash return, and since the cash flow from most real estate limited partnerships is sheltered, taxpayers must generate substantial amounts of MLP passive income in order to offset small amounts of passive tax losses. The large amount of capital investment required to generate income to utilize a small amount of passive tax losses discourages taxpayers from using MLPs for that purpose.

3. Real Estate Pass-Through Entities

Congress may also give consideration to the creation of one pass-through entity for tax purposes. In such an event, ICSC would recommend that such an entity possess investment and tax characteristics as flexible as the partnership vehicle. Alternatively, given the special characteristics of real estate and natural resource investments, the creation of an entity with the flexibility of the partnership would be appropriate at least for such activities.

ICSC appreciates the opportunity to submit these comments and hopes that they are of use to you.

WRITTEN TESTIMONY PRESENTED TO THE UNITED STATES SENATE COMMITTEE ON FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT HEARINGS ON MASTER LIMITED PARTNERSHIPS

July 21, 1987

HISTORICAL COMMENTS

International Paper Company ("IP") is the world's largest paper company and through its majority owned master limited partnership, IP Timberlands, Ltd., (hereinafter referred to as IPT) IP controls over 7 million acres of timberland, which we believe is the largest single concentration of timberland ownership next to that held by the federal government.

IP is principally engaged in the manufacture and sale of products in four forest products industry segments -- namely, pulp and paper, paperboard and packaging, wholesale building materials distribution; and wood products and resources. In addition, IP manufactures non-woven textile products and, through subsidiaries, is engaged in the development of real estate and mineral properties, the operation of a contract oil and gas drilling business and agriculture.

During the period from 1980 through 1985, while most of the country was in a recession, the forest products industry was in a depression. Substantially reduced earnings levels and low stock prices relative to book value combined to present management with a serious dilemma, that is, how to increase earnings and/or the company's stock value to a level that could support either the debt or equity financing necessary to raise capital.

In an effort to improve the company's stock value, management concentrated on ways to enhance asset values. Management believed that our timberland resource base represented an asset that was given little or no recognition by investors. This was the case principally because the economics of timberland ownership were so closely entwined with IP's manufacturing operations that investors did not have the opportunity to understand the economics of timberland ownership as a separate business. Traditionally, non-corporate timberland ownership has been limited to wealthy investors with substantial sums available to invest over long periods of time and those who wish to make long term investments in purchasing and managing land.

IP's management, therefore, set out to find a vehicle that would:

- **Increase the market value of company stock to a level commensurate with the economic value of its asset base.**
- **Provide for a liquid form of investment that would attract all investors and not just the wealthy.**
- **Permit monetization of an asset as a means of raising capital.**
- **Permit continued control of a vital resource base.**
- **Demonstrate the economics of timberland ownership to the investing public.**

After a complete review, IP's management determined that a limited partnership was the best means to realize the above objectives.

Prior to March of 1985, IP's timber resource base consisted of direct ownership or control of approximately 7 million acres of timberland in the United States. In March of 1985, IP formed IPT, a Texas limited partnership, to succeed to substantially all of IP's timberland resource base. IPT features two distinct classes of ownership interest, Class A and Class B depositary units. The Class A and Class B units differ in several respects, the most important being their participation in partnership cash flow and earnings. The Class A depositary units, which trade on the New York Stock Exchange, share in 95% of the cash flow and earnings from timber harvest during the first 15 years of the partnership (1985-1999). Thereafter, the units share in only 4% of timber harvest revenues. The Class B depositary units, which are owned entirely by IP, share in 4% of the cash flow and earnings for the first 15 years and 95% thereafter. The remaining 1% of cash flow and earnings goes to the general partners. After the initial public offering in March of 1985 which resulted in 5% of the Class A units being held by investors, a secondary offer ensued in October of 1985 wherein an additional 11% of the Class A units were sold by IP leaving the company with its present ownership of 84% of the Class A units and 100% of the Class B units.

RESULTS OBTAINED FROM THE CREATION OF IP TIMBERLANDS, LTD.

IP's timberlands, which had an historical book value of $800 million, represented approximately 14% of the company's total asset base. These same timberland assets were valued at $3 billion by both independent appraisals and subsequently by the marketplace in connection with the formation of IPT. Since the creation of the partnership, IP's stock value has increased over 100%, much of which management believes can be attributed to the formation of IPT as well as improved economic conditions within the industry. Moreover, IPT's contribution to the stock performance lent additional leverage and support to IP for further equity and debt financing required for the company's capital expenditure program of approximately $500 million annually.

Further, the modest price (around $25 per unit) and liquidity of the partnership unit provided IP with the opportunity to raise essential capital from a new source --- "the middle income investor"---.

In summary, the business and economic reasons outlined above were the principle criteria for the formation of IPT. While taxes are always a consideration in the selection of a business entity, the selection of partnership form did little to change tax consequences since substantially all of IPT's income is still being taxed at the corporate level. In fact, the main tax reasons why IP chose the partnership form were that (1) it placed all partners on an equal footing -- e.g. all partners share in only the future appreciation of the timberland assets since the appreciation existing at date of formation is attributed to IP under partnership tax law -- (2) it allowed IP to report the current taxable earnings of the partnership in the company's consolidated return without regard to its percentage ownership of the partnership.

REBUTTAL TO CONCERNS RAISED AGAINST MASTER LIMITED PARTNERSHIPS ("MLP'S")

Over the course of the last several years concerns have been raised about MLP's and attempts have been made to alter their tax status. However, as we hope to demonstrate in this testimony, these concerns as they relate to IP Timberlands, Ltd. and many other MLP's in existence today, do not provide sufficient support to alter or change the tax treatment of these entities.

The more significant concerns raised by critics are: (1) MLP's are so similar to corporations that they should be taxed as corporations; (2) avoidance of the corporate tax by MLP's will lead to the disincorporation of American companies; (3) disincorporation will cause substantial loss of tax revenue and; (4) the complexity of MLP's cause substantial compliance problems.

(1) SIMILARITY TO CORPORATIONS

Notwithstanding that IPT and most other MLP's are correctly classified as non-corporate entities under long established tax law and regulations, some critics believe that the free transferability of interest characteristic intrinsic to both corporations and MLP's should justify the imposition of corporate tax. However, to elevate this privilege to the most important characteristic in determining corporate status would be extremely inappropriate. Otherwise, existing corporations in this country, of which 98% are not publicly traded, would fall prone to reclassification for income tax purposes. Moreover, consider the fact that there are many large publicly-registered but unlisted partnerships with thousands of partners. These partnerships are as large as MLP's and conduct similar type businesses. According to a tax report submitted to the Senate Finance Committee in 1983 there were, as of 1980, 676 partnerships with more than 1,000 partners each, grossing nearly $6 billion with net earnings of nearly $1.5 billion. To distinguish these delisted partnerships from MLP's because the latter trades more freely in an orderly and established market would be discriminatory and unfair tax policy. In fact, non-traded partnership interests could theoretically trade freely outside the conventional marketplace. Moreover, publicly registered partnerships that raise capital through private investment are required by federal and state securities laws to sell interests to accredited investors. Generally, to be accredited, an investor must have net worth in excess of $1 million or income in excess of $200,000. Accordingly, a rule that would require reclassification because of tradeability would discriminate against the middle income investors in favor of the wealthy investors.

(2) DISINCORPORATION

Outspoken critics have claimed that the advent of MLP's will lead to the disincorporation of American companies. This concern most likely originated from the Economic Recovery Act of 1981 which reduced the maximum tax on individuals from 70% to 50%. The reduction substantially reduced the spread between corporate and individual rates and thereby seemingly lessened the benefits of incorporation. This claim was further amplified through the passage of the Tax Reform Act of 1986 which reduced the individual rate below the corporate rate.

Notwithstanding the change in the rate differential, a mass exodus to the partnership format is highly unlikely and illusionary at best. First and foremost, mass disincorporation to the MLP format presupposes that any type of business activity could effectively operate within the MLP format. If that were the case, IP, after closely reviewing the partnership form of doing business, would have elected to disincorporate its entire business operations.

Furthermore, units of a MLP are perceived in the marketplace as yield driven investments. Thus, their marketability is based upon an anticipated cash return to investors. The average cash return on MLP's units selling in the marketplace today is between 10 to 11%. Since many public corporations have capital intensive businesses, it is extremely difficult to conceive that most of these corporations could disincorporate to MLP format and establish a cash distribution policy to meet the required yields of the MLP's marketplace while simultaneously retaining sufficient cash for reinvestment needs. Moreover, the foremost disadvantage has to be the inaccessibility to the institutional investor. Pension funds and other tax-exempt entities have become the most predominant players in the capital market today. However, the presence of unrelated business taxable income (UBTI) effectively prohibits these entities from investing in MLP's.

In summary, the MLP formation is limited to unique business assets such as IPT's timberlands which generate a very predictable cash flow and can operate without need of institutional capital and major reinvestment requirements.

(3) REVENUE LOSS

One of the most severe criticisms of MLP's is fear of the erosion of the corporate tax base. This concern assumes that a substantial number of incorporated business activities will disincorporate and that a substantial number of future business activities will not choose the corporate form.

For reasons just mentioned above, it is highly unlikely that a substantial number of corporations will disincorporate or that future businesses will take the form of the MLP. Moreover, to the extent that businesses have taken the MLP form there would appear to be, if anything, a revenue gain. This conclusion can be reached by examining how MLP's are formed.

Approximately one-third of the MLP's to date were formed through the method commonly referred to as the "roll-up". Under this method a MLP is formed by rolling up previously existing non-traded partnerships into a traded partnership. Nearly one-half of existing MLP's were formed by way of a "roll-out". Under this method sponsor corporations contributed assets to a MLP in exchange for units. The remainder of the existing MLP's were formed by various methods including an offshoot of the "roll-out" method called the "acquisition method" or "acquisition MLP". Under this method a MLP is formed and a taxable acquisition is made of the sponsor corporation's assets following a public offering of units.

MLP's formed under the roll-up method can be viewed as revenue neutral at best since the prior non-traded partnerships were not subject to the corporate tax. If anything, the formation of these MLP's created a revenue gain due to the triggering of recapture income and the loss of percentage depletion.

MLP's formed under the acquisition method cause the corporate sponsor to be fully taxed on the gain realized from the sale of assets. Accordingly, formation of MLP's under this method should not be viewed as an erosion of the corporate tax base, but, in fact, as an acceleration of the corporate tax that would have been realized on the future income stream from the properties that were sold.

MLP's formed under the roll-out method generally cause no immediate taxation to the sponsor corporation. However, the tax basis in the property contributed is substituted in the basis of the partnership units received by the sponsor corporation which, if sold in a secondary offering, will immediately trigger the inherent gain in the assets at the corporate rate. This result is not any different from a corporation selling its assets outright. Once again, an acceleration of future corporate tax will occur. Furthermore, as the MLP sells partnership property received from the sponsor corporation, the inherent gain in this property is allocated to the sponsor corporation under partnership tax law.

IP Timberlands, Ltd. was formed under the roll-out method. IP contributed substantially all of its timberland asset base to IPT in exchange for Class A and Class B units. Under partnership tax rules any inherent gain in the property contributed is allocated back to the contributing partner when the partnership sells such property. In 1985 and 1986 IPT had distributable taxable income of $59 and $80 million, respectively. Because of partnership tax rules and IP's significant holdings in IPT, 95% of the distributable taxable income for 1985 and 93% for 1986 was allocated to the company. Accordingly, substantially all of the taxable income of IPT is being taxed at the corporate level. Moreover, IP sold some of its Class A units in a secondary offering. This sale caused the immediate recognition of $62 million of gain representing part of the inherent gain in the timberland assets contributed to IPT.

Finally, the perceived notion that tax revenue is lost because of the spread between shareholder taxation and individual taxation is misleading and unfounded. Critics have preached that the spread between the maximum tax applicable to corporate profits of 52% (34% corporate tax and 28% shareholder tax on dividends, as planned under the TRA of 86) and the maximum rate to individuals of 28% causes a substantial loss to tax revenue. However, it must be recognized that the actual spread is significantly less because few, if any, corporations pay taxes at the maximum rate (albeit, subject to the alternative minimum tax) or annually distribute their entire net earnings. Corporations generally pay dividends far less than their net earnings because of reinvestment needs and debt requirements. The simplest way of avoiding taxation of corporate profits is the use of debt capital as a substitution of equity capital. With the increasing use of debt, witness the emergence of "leveraged buyouts" and "junk bonds", corporate borrowers are able to substantially reduce corporate profits through interest deductions. Attendant to this borrowing is the need for indefinite retention of corporate profits to service the debt and, thus, the minimization of dividends. On the other side of this equation are the shareholders and the lenders, principally tax exempt entities such as pension trusts and other institutions which pay little or no tax. Approximately 60% of the outstanding shares of IP are held by institutional investors such as these. This fact pattern is not at all different from most other publicly-traded corporations. Thus, a substantial portion of the dividends that are paid are being subject to little or no tax at all. The same argument, but to a greater extent, can be made for receivers of interest since the institutional investors are the largest lenders in the debt capital market. For these reasons and others, the total tax realized on corporate profits is far from the maximum of 52%.

Contrast this situation to the MLP environment. Most MLP's in existence today, including ours, carry little or no debt. As stated above, the cash distribution requirements of MLP's preclude the carrying of significant debt. Conversely, most capital raised in the MLP market has been used to replace debt of the corporate sponsor thereby increasing taxable earnings through the reduction of interest expense and thus increasing the corporate tax. Additionally, 100% of the MLP's taxable income is deemed distributed annually to taxpaying individuals or corporations.

Based on the aforementioned analysis, it is extremely difficult to claim that MLP's such as ours may or will cause a loss of tax revenue. On the contrary, it seems more realistic that IP Timberlands, Ltd. as well as other MLP's have and will cause a revenue gain.

(4) COMPLIANCE

Critics have feared that because of the size and complexity of MLP's and the constant transfer of partnership units, tax compliance cannot be achieved. Although compliance for MLP's is complex, it is not materially different from the problems associated with small partnerships or large non-publicly traded partnerships.

Moreover, substantial sums of money have been spent to develop sophisticated software programs to administer compliance. These systems provide specific tax information to unitholders about their unit ownership so that their distributive share of partnership taxable income can be determined. Additionally, the new nominee reporting rules will greatly assist and enhance the compliance efforts.

CONCLUSION

The MLP has provided IP and other businesses with significant economic benefits. Its framework has allowed the monetization of substantially undervalued assets, the raising of essential capital and access to capital of moderate investors.

Most MLP's, as was the case with IP Timberlands, Ltd., were not formed to avoid the corporate tax. Conversely, the formation of MLP's may very well be a gain to the revenue base. Finally, well established tax rules, which have always given business the opportunity to choose which form they operate under, provide a fair and equitable means of distinguishing a corporation from a pass-through entity. To change these rules because of unfounded concerns will prohibit a form of doing business which has been found to be economically efficient and necessary.

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FINLEY, KUMBLE, WAGNER, HEINE,
UNDERBERG, MANLEY, MYERSON & CASEY

STATEMENT OF
LESLIE H. LOFFMAN
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
UNITED STATES SENATE
JULY 21, 1987

Mr. Chairman and Members of the Subcommittee:

My name is Leslie H. Loffman. I am a Partner in the New York office of the law firm of Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey. I also serve on the faculty of New York University as an Adjunct Associate Professor. Although a significant portion of my practice is related to the representation of partnerships, I am not appearing on behalf of any client. I am appearing on my own behalf because of my interest in addressing what I consider to be certain of the major tax policy considerations in evaluating the tax treatment of master limited partnerships ("MLPs").

I have focused my comments on five areas of inquiry: (i) the impact of the Tax Reform Act of 1986 (the "1986 Act") on the choice of entity; (ii) the revenue impact of taxing MLPs as corporations; (iii) the application of existing Treasury regulations respecting entity classification to MLPs; (iv) the administrative and compliance concerns respecting MLPs; and (v) the characterization of MLP income as portfolio or passive. Each of these topics is discussed in detail below.

I. Impact of 1986 Act

The lowering of the maximum tax rates under the 1986 Act, to 28 percent (beginning in 1988) for individuals and 34 percent for corporate taxpayers, for the first time results in the maximum corporate rate exceeding the maximum individual rate. The 1986 Act also repealed the preferential tax rate on capital gains and eliminated the so-called General Utilities doctrine[1] in which sales or distributions as part of a liquidation of a corporation generally were exempt from the corporate level tax. The impact of such provisions has created a bias against choosing the corporate form. However, it would be improper for Congress to treat MLPs as the problem rather than as a symptom of the 1986 Act provisions.

Assistant Secretary Mentz, in testimony before the House Subcommittee on Select Revenues,[2] recognized that the 1986 Act increased the incentive to conduct business in non-corporate form. In support of this argument, Assistant Secretary Mentz cited the fact that the number of corporations that have elected to be taxed under the pass-through rules of subchapter S for the 5 months ended May 31, 1987 exceeded the number of such elections for the prior two years. In addition to the bias for qualifying corporations to elect S status, the provisions of the 1986 Act insure that small, medium or large entities (whether publicly traded or not) will opt for non-corporate status (i.e., partnership, real estate investment trust, regulated investment company or real estate mortgage investment conduit). Would the treatment of MLPs as corporations solve this problem? Absolutely and emphatically not.

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[1] General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

[2] Statement of J. Roger Mentz, Assistant Secretary (Tax Policy) Department of the Treasury, Before the Subcommittee on Select Revenues, Committee on Ways and Means, U.S. House of Representatives, June 30, 1987 (hereinafter referred to as the 1987 Hearings).

As described more fully below, apart from the passive vs. portfolio characterization of MLPs income, taxing MLPs as corporations will produce no revenue to the Treasury and may in fact produce a revenue loss. Therefore, I suggest that Treasury refocus its attention on the provisions of the 1986 Act. One suggestion would be to reinstitute the General Utilities doctrine. The fisc could be protected against wholesale liquidations into partnership form by enacting so-called "anti-churning" rules to prevent businesses which were previously conducted in corporate form from reconstituting themselves as partnerships where there has been no substantial change in the ownership of such "new" entity.

II. The Revenue Impact of Taxing MLPs as Corporations.

Before addressing the more substantive issues respecting the revenue impact of treating MLPs as corporations, it is important that the facts be set forth and various myths dispelled.

It should be understood that MLPs are utilized almost exclusively as a technique for raising new capital from the public. In general, substantially all the capital raised from the public through MLPs is raised by corporations who sponsor the MLPs to pay off debt, or as a substitute for new indebtedness. MLPs permit corporations to strengthen their financial condition by eliminating debt and without diluting the control of existing shareholders. Thus, the MLP is a useful alternative of raising capital and is not a tax avoidance scheme plotted by tax accountants and lawyers.

The major myth that should be dispelled is that the continued use of MLPs will result in the disincorporation of America.[3] There are a number of reasons why this will not happen. First, the repeal of the General Utilities doctrine in the 1986 Act insures that the double tax will in most cases be paid. Secondly, corporate, tax-exempt and foreign investors are likely to shy away from operating businesses which are conducted in partnership form. In general, corporate investors will not be entitled to the 80% dividends received deduction of Code Section 243 with respect to partnership distributions, tax-exempt investors' earnings from limited partnership investments are subject to taxation as unrelated business taxable income and foreign investors in partnerships conducting U.S. trade or businesses will be deemed to be engaged in a U.S. trade or business and thus are subject to U.S. taxation on their allocable share of partnership profits. Because these groups of investors constitute a major source of funds, it is unlikely that new entities to be formed, or existing corporations, will want to exclude these major sources of investment capital.

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[3] The press may have sparked this controversy. As early as 1983, Forbes (Mack, Disincorporating America (Forbes, August 1, 1983) was saying that the advent of MLPs would disincorporate America. Only recently has Forbes come to realize that its earlier position was overstated (A Little Problem (Forbes, Dec. 1, 1986)).

The second myth that needs to be dispelled is that taxing MLPs as corporations will erode the corporate tax base. As described above, the existing corporate base is not subject to erosion through disincorporation of existing corporations; thus, the only potential for revenue loss is when a particular business activity decides to use the MLP format to raise new capital that would otherwise have been raised by a corporation. Based on the following facts, it quickly becomes apparent that Assistant Secretary Mentz' fear of a "hemorrhage" of corporate tax revenues is an overstatement. First, only a small portion of new investments made by MLPs could result in any loss of revenues. Thus, for example, many activities which have traditionally been conducted in partnership form will, if the MLP format is double-taxed, find some other single-taxed activity. Thus, for example, a real estate venture could opt to use a partnership whose interests are not publicly traded or, if it qualifies, a real estate investment trust.

Subjecting MLPs to a double tax will not result in major revenue collections because of the way in which corporations could be expected to replace MLP capital if MLPs are double taxed. In general, to the extent that MLP financing is unavailable, corporations will be able to utilize three alternative sources of capital formation:

(i) debt issuance;
(ii) retained earnings; and
(iii) issuance of new stock.

Only the issuance of stock will result in the ultimate collection of the double tax. Investment financed by the issuance of corporate stock gives rise to double tax revenues when the investment generates income and the income is paid out as dividends. However, John E. Chapoton, a former Assistant Secretary (Tax Policy) Department of the Treasury, in his statement at the 1987 Hearings, noted that only about 8% of corporate investment is financed by new share issues. The issuance of debt will, at best, be revenue neutral and will result in a revenue loss to the extent that the debt is held by tax-exempt or foreign investors. Finally, the retention of earnings will produce a significant revenue loss.

In terms of measuring any potential revenue loss from continuing to treat MLPs as partnerships for tax purposes, it is important to put the use of MLPs in perspective. According to Robert A. Stanger's testimony at the 1987 Hearings, 60% of MLP interests are retained by their corporate sponsors, thereby possibly maintaining the double tax.[4] Moreover, as described above, many of the MLPs will be able to use another single tax format. In addition, because most of the revenues of MLPs are tax-sheltered, the total taxable income of all MLPs is relatively small. Accordingly, imposing a double tax on such income will result in relatively little tax revenue gain.[5] Thus, apart from the passive vs. portfolio characterization of MLP income, the revenues should be small and such recharacterization may indeed result in a revenue loss when taking into account the possibility that MLP capital will be replaced by corporate debt supplied by non-taxpaying entities.

Finally, Mr. Chapoton, in his statement at the 1987 Hearings stated that most capital investment in the U.S. bears, at most, a single tax. Thus, to throw MLPs into the double tax mode without considering the total integration of the tax system would be premature.

III. Classification

The tax laws have always permitted taxpayers to choose the form of organization by which to conduct their business activities. The Treasury and courts[6] have been charged with the responsibility of classifying such organizations as partnerships, trusts or as associations taxable as corporations. In general, Treasury regulations provide that an organization will be classified as a corporation if (i) the organization is comprised of associates who have an objective to carry on a business or financial enterprise and divide the gains and (ii) the entity has more than two of the following four principal corporate characteristics: (1) continuity of life; (2) centralization of management; (3) limited liability and (4) free transferability of interests.

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[4] A double tax may not be imposed. Thus, for example, notwithstanding all the attention the Boston Celtics' MLP received, it is noteworthy that the corporate owner of the Celtics was operating as an S corporation and thus was not paying a corporate level tax.

[5] *See* statements of Assistant Secretary Mentz and Robert A. Stanger at the 1987 Hearings.

[6] *See*, *e.g.*, *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

Although MLPs have two of the corporate characteristics (free transferability and centralized management), they typically lack continuity of life. Accordingly, if the MLP has a general partner with substantial assets against which creditors can proceed, the MLP will lack limited liability and will therefore be classified as a partnership for tax purposes.

Many have argued that current Treasury regulations do not adequately set an appropriate dividing line in characterizing entities and that MLPs more closely resemble corporations. This conclusion appears to be grounded on the public trading of MLP units,[7] merely one consideration which by no means should dispose of the issue of tax status. Making free transferability the predominant characteristic makes no sense in a world where 98% of all corporations are not publicly traded. Moreover, most publicly traded partnership units are owned by small and moderate income investors who would be shut out of investments that wealthy investors would still have available to them. This latter argument cannot be emphasized enough. How can Congress consider taxing MLPs as corporations merely because such partnerships offer liquidity to their investors?

There are significant economic differences between electing corporate and partnership form, independent of the publicly traded nature of ownership units.

(a) Limited liability - As noted above, at least one general partner must maintain a substantial net worth. In addition, limited partners may, under state law, be liable for repayment of distributions if necessary to satisfy creditors. Moreover, there is always a risk that a limited partner could be treated as a general partner (liable for the debts and obligations of the partnership) if such limited partner participated in the management of the partnership.

(b) Investor Taxation - A corporate shareholder is taxed on corporate income only when it is distributed to him whereas a partner is required to include in his income currently his allocable share of partnership income even if no cash is distributed to him.

(c) Complexity - A partnership is more complex to operate than a corporation. Thus, for example there are significant costs involved in accounting for partners' shares of tax items.

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[7] Some have suggested that partnerships with more than some maximum number of investors should be taxed as corporations even if interests in such partnerships are not publicly traded. Treasury correctly rejected this suggestion in its testimony at the 1987 Hearings. See also Treas. Reg. § 301.7701-3(b)(2), Example (2) in which an entity with 900 limited partners whose interests were freely transferable (but not publicly traded) was nevertheless classified as a partnership.

(d) Existence - A limited partnership's life is limited to a fixed number of years and there will also be a technical dissolution of the partnership law in the event of the death, insanity or bankruptcy of a general partner.

Based on just these few examples, it is apparent that there are real and significant economic consequences of operating in partnership form. It is these consequences which should control classification; to rely exclusively on the tradeability of partnership interests makes no sense at all.

IV. Administrative and Compliance Concerns

Assistant Secretary Mentz, in his testimony at the 1987 Hearings, correctly stated that treating MLPs as partnerships creates "difficult accounting and tax collection issues." However, partnership tax experts agree that most of these problems result because of the complexity of the partnership rules themselves, and that a number of these complexities could be alleviated through the promulgation of regulations by the Treasury. Before I discuss several aspects of the technical accounting and audit problems, I think it is imperative that these problems be put in perspective. First, the administrative concerns, although important, do not alone warrant taxing MLPs as corporations; to the extent that technical administrative problems exist, such problems should be faced and dealt with accordingly irrespective of any action by Congress on the MLP classification question.

Secondly, as I stated above, the Treasury has sufficient regulatory authority to deal with much of the complexity. I question how the Treasury can be using the complexity in administering the partnership rules as a rallying cry for treatment of MLPs as corporations when it has not attempted to "fix" any of the perceived problems.

A number of MLPs and their accountants have invested an enormous amount of time, energy and resources in addressing IRS- and partner- reporting requirements through the use of highly sophisticated computer programs. Assistant Secretary Mentz acknowledged this point in his testimony at the 1987 Hearings by agreeing that MLPs have attempted to comply with the law. He noted, however, that "[a]ll MLPs employ accounting conventions to simplify application of the partnership tax rules and maintain interchangeability of the limited partnership interests." Assistant Secretary Mentz further stated that "certain of these conventions, although not adopted for a tax avoidance purpose, are inconsistent with the statute and/or regulations." [Emphasis added].

The following discussion addresses several aspects of the federal accounting and audit considerations of continuing to tax MLPs as partnerships:

1. Section 704(c).

In general, when property is contributed to a partnership, the partnership is required to allocate depreciation, depletion and gain or loss with respect to such contributed property so as to take account of the difference between the partnership's basis for the property and the fair market value of the property at the time of contribution. The major technical tax issue raised by Section 704(c) is that partnership interests in MLPs which have identical economic rights may possess different tax characteristics.[8] Assistant Secretary Mentz points out in his attack against MLPs that many MLPs use "curative allocations" to offset the different tax characteristics and that such allocations are not permitted under existing regulations. However, the Senate Finance Committee report accompanying the Tax Reform Act of 1984 stated that "it is anticipated that the regulations will permit partners to agree to a more rapid elimination of disparities, between the value and adjusted basis of contributed property . . . provided that there is no tax avoidance potential." [Emphasis added].[9] Thus, if Treasury saw fit, it could permit curative allocations where no tax avoidance potential was present. Unfortunately, however, new regulations have not been promulgated by Treasury since amendments were made to Section 704(c) in 1984.

In addition, the Treasury's existing Section 704(c) regulations may be responsible for many of the fungibility problems now existing. Under current Treasury regulations, the total depreciation, depletion, gain or loss allocated to partners under Section 704(c) cannot exceed the amount of depreciation or depletion allowable to, or gain or loss realized by, the partnership (the "ceiling rule"). The elimination of the ceiling rule by Treasury, when it finally issues its regulations, would make sound tax policy independent of the MLP issue and also would eliminate most of the foregoing fungibility problems faced by MLPs.

2. Partnership Audit and Collection of Taxes.

Code Section 6221 provides that the tax treatment of any partnership item generally be determined at the partnership level. However, any resulting deficiency must be collected from the individual partners. It is obvious that where there are a large number of partners and the deficiency of each limited partner is small, the IRS might find it too expensive to collect all taxes due from the numerous partners. This problem could easily be solved by Congress requiring MLPs to pay any tax deficiency on behalf of their partners, making certain assumptions as to the proper tax brackets of such partners.

3. Nominee Reporting.

Code Section 6031(c), as added by the Tax Reform Act of 1986, imposes for the first time an obligation on nominees to (i) provide information (e.g., the name and address) respecting beneficial owners and (ii) furnish tax information provided by the partnership to the beneficial owner. As enacted, this provision contained no "teeth" (i.e., no penalty) to promote compliance with the rule. However, if enacted, Section 115(a) of the Technical Corrections Bill of 1987 (H.R. 2636) would provide that a nominee's failure to supply the required information to the partnership would subject the nominee to the general penalty for failure to furnish payee statements of Code Section 6722 ($50 per failure up to a maximum of $100,000 per calendar year). With the enactment of Section 6031(c), and assuming that the Technical Corrections Bill is enacted into law, any compliance problems associated with the lack of information have been solved.

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[8] In fact, only MLPs that raise all cash in a single all cash offering would avoid a fungibility problem.

[9] S. Rep. 98-169, 98th Cong. 2d Sess. 214-15 (April 2, 1984).

V. Passive Loss Rules

In general, income from a limited partnership is passive income which may be sheltered by passive losses. In contrast, dividends and interest are portfolio income which cannot be so sheltered.[10] The Treasury is empowered to use its authority under Section 469(k)(3) to issue regulations which would reclassify otherwise passive income as portfolio income. The Treasury may be reluctant to exercise its authority in the context of a "heads I win, tails you lose" atmosphere (i.e., income will be portfolio but losses will be passive). Although, as described below, I believe it would be bad tax policy to treat all MLP income as portfolio based on whether interests in the MLP generating such income are publicly traded, if it were determined that reclassifying MLP income as portfolio would generate significant revenues such reclassification should be considered by Congress.

The fact that a limited partnership's interests are traded on a national exchange, or the fact that the partnership has more than a certain number of partners, should not be relevant in determining the passive or portfolio character of its income. In contrast, if an MLP represents a mere restructuring of an existing trade or business formerly conducted as a corporation into a partnership for the purpose of generating passive income, the successor MLP should be treated as a source of portfolio income. One possibility would be to apply anti-churning rules similar to the provisions of former Code Section 168(e)(4). Thus, where an MLP has been created to succeed to a business conducted previously in corporate form, the MLP should be treated no differently from the entity it succeeded if there is sufficient continuity of ownership.

A "catch-all" rule treating all publicly traded MLPs as generators of portfolio income is unnecessarily broad and is based on the assumption that such investments generally lack risk and are "portfolio income flavored." However, this assumption is incorrect as applied to MLPs generally. It is incorrect to assume that all publicly traded MLPs bear risks not significantly different from high yield debt-type instruments. Absent a guaranteed or insured return, the analogy to debt instruments is improper. The activities of MLPs include numerous types of business activities (e.g., real estate, equipment leasing, cable television and oil and gas) which involve significant expenses and investment risk. Such factors should be the only relevant factors which bear on the determination of the MLP's "passive" or "portfolio" status.

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[10] Assistant Secretary Mentz has testified that taxpayers will be able to avoid the passive loss limitation by using MLPs to generate passive income which may offset otherwise non-deductible losses. This concern is not real. Robert A. Stanger, in his submission at the 1987 Hearings, concluded that 79% of the yield of MLPs will not be taxable income. It is inconceivable that an investor who is looking for a 10% cash return on investment which is 80% tax sheltered would invest $500,000 to permit him to offset $10,000 of otherwise non-deductible passive losses.

Income derived from a partnership's active business should be reclassified as portfolio income to the limited partners only where those investors are assured of a positive return on their invested capital, as the Senate Finance Committee Report accompanying the 1986 Act suggests.[11] Examples would include partnerships in which the investors are guaranteed a minimum return. The concepts under prior Code Section 163(d) and Prop. Reg. § 1.57-3(c) for identifying net leases by virtue of an assured return are well-suited for use in determining whether income should be classified as portfolio income by virtue of a guaranteed return.

The 1986 Act Senate Report refers to the lack of significant expenses as a factor which will recast the income of an entity as portfolio.[12] This test requires a determination of whether the investor is substantially protected from loss. If two partnerships acquire real estate for cash and otherwise operate identically and one elects to list its units for quotation on a national exchange, equality of treatment should result (i.e., the only relevant consideration should be whether there is a guaranteed return for investors and not whether the limited partnership's interests are publicly traded).

Conclusion

In summary, for both economic and sound tax policy reasons, MLPs should not be classified as corporations for tax purposes unless it can be demonstrated that there would be a significant loss of tax revenues. As discussed above, such classification would produce little or no tax revenues and could produce a revenue loss. Any administrative concerns respecting MLPs can easily be solved. Finally, although treating all MLP income as portfolio would not be sound tax policy, such action should be considered if doing so would generate significant tax revenues.

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[11] S. Rep. No. 99-313, 99th Cong. 2d Sess. 731, note 18 (May 29, 1986) (hereinafter referred to as the "1986 Act Senate Report").

[12] Id. at 728-29.

MISSION RESOURCES INC.

SIDNEY F. GAGE
SENIOR VICE PRESIDENT
CHIEF FINANCIAL OFFICER

July 8, 1987

Committee on Finance
United States Senate
205 Dirksen Building
Washington, D.C. 20510

RE: Hearings on Taxation of Publicly Traded Limited Partnerships as Corporations

Ladies and Gentlemen:

Mission Resources is an independent oil and gas producer active in California, Texas and other states. Mission operates wells producing over 2,000 bbls of oil and 4,500 Mcf of gas per day, and Mission and its affiliates have interests in over 600 wells operated by others. Over the last 15 years, Mission has drilled or participated in over 1,500 new wells in the United States. Mission employs 55 people.

In past years, the most important source of capital for Mission and many other independent oil producers has been through limited partnerships with individual investors. Recent changes in tax laws virtually eliminate this source of new capital needed by independent producers to replace depleting oil and gas reserves through drilling and development. In 1985 (the latest figures available from IPAA) independents expended $16 billion on U.S. exploration and development, nearly matching the $17 billion spent by the major companies.

We believe that for small independent oil and gas companies to survive in today's environment of lower oil prices and scarce capital, they need to be able to do two things: consolidate operations for efficiency, and raise capital to find more domestic reserves of oil and gas. In the last five years, the publicly traded "master" limited partnership ("MLP") has emerged as a new form of business structure which gives the independents a way to accomplish these two goals. The MLP makes it easier to combine various oil and gas operations in one entity. Further, the MLP's acceptance in the financial markets gives independents access to capital they may never have as small corporations and that they can no longer get through traditional limited partnerships.

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Committee on Finance
United States Senate
July 8, 1987

In short, the MLP is a ray of hope for financially beleaguered independent oil companies. There are 30 oil and gas MLPs in existence now, a number of others being formed, and probably more in the future as our industry continues its restructuring. Taxing the MLPs out of existence would be a severe blow to the already battered independent oil companies and to our domestic energy security.

Sincerely,

Sidney F. Gage

SFG:ak

Statement of the
NATIONAL ASSOCIATION OF REALTORS®
THE WORLD'S LARGEST TRADE ASSOCIATION

My name is Jeff Rosenthal. I am a partner in the Chicago office of Peat, Marwick, Main & Co. I am testifying on behalf of the NATIONAL ASSOCIATION OF REALTORS® and the Real Estate Securities and Syndication Institute (RESSI), which is an affiliate of the REALTOR® organization. The NATIONAL ASSOCIATION OF REALTORS® is an umbrella organization consisting of 750,000 members with interests that span the breadth of real estate activities, including the ownership, operation, management, development, appraisal, and sale of single family residences and commercial real estate, including both residential and non-residential structures. RESSI represents 3,000 individuals and corporate members who specialize in investment and management of income-producing real estate and mortgage loans as well as the creation, issuance, analysis, and management of real estate securities. The group real estate investment programs in which these individuals are involved range from relatively small private placements of undeveloped land to multi-million dollar group real estate investment programs involving large real estate complexes. Many of the offerings in the post-tax reform era are designed to attract middle-income investors by offering units priced between $1,000-$5,000 for investment opportunities in diversified mortgage loans and/or the ownership of rental real estate.

My statement is organized and presented in the following manner. First, I shall summarize the recommendations that RESSI and the NATIONAL ASSOCIATION OF REALTORS® would like this Subcommittee and the Congress as a whole to consider in connection with its study of pass-through entities and MLPs. Secondly, I shall discuss in detail the reasons underlying our contention that the current tax treatment of both limited partnerships generally and of limited partnerships which own or make mortgage loans on rental real estate are appropriate and should be maintained. Thirdly, I shall respond to suggestions appearing in recent publications and articles arguing for the creation of a model pass-through entity to replace the partnership as an investment vehicle for real estate. And finally, I have prepared an analysis of recent suggestions that the entity classification rules should be replaced with a new standard that accentuates the importance of the limited liability test to the exclusion of other factors that are currently applied under existing Treasury regulations.

I. Summary of Recommendations to this Subcommittee:

A. The tax treatment of limited partnerships as a pass-through entity under present law should be maintained, including the tax treatment of Master Limited Partnerships (MLPs). A Master Limited Partnership or MLP is defined as a limited partnership (formed pursuant to the laws of any state) having equity securities which are registered under the Securities Act of 1933 and are either (i) traded on a national securities exchange registered under the Securities Exchange Act of 1934 or (ii) designated as national market system securities pursuant to the Securities Exchange Act of 1934 and the rules and regulations adopted thereunder. Such securities are hereinafter called "Listed Securities." Simply stated, an MLP is a partnership that has been publicly offered and has Listed Securities.

The tax treatment of partnerships, including MLPs, should be maintained as an effective capital formation technique to attract investor capital and particularly middle-income investor capital. As the ensuing discussion more clearly indicates, MLPs have been designed to appeal to wage-earners with annual incomes as low as $25,000 by offering Listed Securities priced between $1,000 to $5,000. Moreover, passage of the 1986 Tax Reform Act has adequately addressed any perceived abuses that may have previously existed. Revisions to the tax rules concerning entity classification, including partnerships and MLPs, are not warranted. If Congress makes a determination, as some have suggested, that the Internal Revenue Code of 1986 should not be reopened for a period of time in order to fairly evaluate the effects of the last two Tax Reform Bills on the nation's economy, then this rationale should also apply to the present tax treatment of Master Limited Partnerships.

B. Although RESSI and the NATIONAL ASSOCIATION OF REALTORS® believe that the present tax treatment of MLPs as a partnership is appropriate, we feel very strongly that the current treatment of MLPs predominantly owning rental real estate or making mortgage loans on rental real estate should be retained. Otherwise, decisions by the Congress to tax real estate MLPs as corporations can only be characterized as a new tax increase levied on real estate, and not as an attempt to preserve the corporate revenue base, as some have claimed. The limited partnership was the traditional investment vehicle used for the acquisition of rental real estate before the advent of tax reform and this practice has continued subsequent to the passage of that legislation. Consequently, legislation to terminate the use of MLPs owning investment real estate would constitute a new tax on investment real estate, which would be in addition to the estimated 50 to 60 billion dollars over a five year period that was assessed on investment real estate in the 1986 Tax Reform Act.

C. If the Congress acts to curb the use of MLPs, including MLPs that principally own rental real estate and/or make mortgage loans on rental real estate, any proposed restrictions should apply only to MLPs as defined above. Any proposal passed by Congress reclassifying MLPs for tax purposes should nevertheless continue to permit partnership taxation for limited partnerships which are either publicly offered or non-publicly offered and do not have Listed Securities. Any proposal to restrict MLPs that limits the use of limited partnerships that do not have Listed Securities and are formed to invest in real estate would deal a crippling blow to investment real estate, the effects of which are magnified by the impact of tax reform. A proposal to tax as a corporation a limited partnership which does not have Listed Securities and which owns real estate and/or holds mortgage loans on real estate would cause real estate limited partnerships to be uncompetitive with alternative forms of investments by drastically reducing the yield from such investments through imposition of the corporate tax. Moreover, the costs to the economy and to the real estate industry of another significant tax increase on real estate would be quite damaging in terms of higher unemployment for the construction industry, which is only now coming to grips with the adverse effects of tax reform. A new tax would also have an especially harsh effect on a capital-intensive industry, such as real estate, with a concommitantly detrimental impact on this country's GNP to which real estate contributes roughly 40% annually.

D. If the Congress decides to consolidate all pass-through entities, such as limited partnerships, RICs, REMICs, or REITs, into a model pass-through entity that would more closely resemble a REIT, as some have suggested, then many of the restrictions governing the qualification test and the asset investment rules currently applicable to REITs must be relaxed in order to provide the entity with the flexibility (which REITs currently lack and that partnerships possess) that is essential to meet the diverse needs of today's investors in a sophisticated real estate market. It should be noted that Congress recognized this need for flexibility in certain real estate investments when it adopted the REMIC as an investment vehicle for mortgage-backed securities.

II. REASONS IN SUPPORT OF RECOMMENDATIONS

A. A Proposal to Tax Real Estate MLPs as Corporations Cannot Be Justified as Necessary to Preserve the Corporate Revenue Base, But Instead Represents a New Tax on Investment Real Estate.

Because investment real estate was held in limited partnership form before the passage of the Tax Reform Act of 1986 and continues to be held primarily through limited partnerships, a proposal of a legislative or regulatory nature to classify limited partnerships with predominantly real estate interests as corporations for tax purposes would represent a new, substantial tax increase on the real estate industry. Investments in rental real estate were never a significant part of the corporate revenue base before passage of tax reform and has remained outside of the corporate revenue base after its enactment. Thus, efforts to tax real estate MLPs as corporations and not as partnerships for tax purposes cannot be justified on the grounds that such actions are necessary to preserve the corporate revenue base.

A new tax on real estate in the form of taxing real estate MLPs as corporations for tax purposes would be in addition to the estimated 50 to 60 billion dollar tax increase which the real estate industry paid for the individual and corporate rate reductions contained in the Tax Reform Act of 1986. These tax increases consist of a combination of various provisions, including: the passive loss limitation that limits the deductibility of passive losses to the income from passive activities, which is defined by statute to include rental real estate; restrictive investment interest rules which significantly limit the deductibility of interest incurred to purchase investment assets, including real estate; reduced depreciation deductions for structures; revisions to the at risk rules; less generous tax incentives for the rehabilitation of historic structures and older buildings; and less attractive tax-exempt bond financing rules pertaining to multi-family housing, among others. The point to emphasize is that the real estate industry, and especially investment real estate, paid a disproportionate share of the tax increases contained in the Tax Reform Act of 1986 to achieve the tax rate reductions for individuals and corporations.

Although it can be argued that legislation to restrict the use of MLPs may be warranted in those instances where an active trade or business disincorporates or chooses the partnership vehicle simply to escape the corporate tax, this rationale cannot be cited as authority for taxing a limited partnership that owns investment real estate as a corporation. Group ownership of and mortgage loans on rental real estate have traditionally been made through a limited partnership and this practice remains unaffected by tax reform. Moreover, the repeal in the Tax Reform Act of 1986 of the General Utilities doctrine, which allowed tax-free corporate liquidations, now predominantly causes the costs in additional taxes of liquidating a corporation to be more expensive than the savings achieved through avoidance of double taxation. The reasons for the use of the limited partnership by the real estate industry are diverse, including both tax and non-tax factors. The major tax reason for the selection of a limited partnership as the principal investment vehicle for real estate is the flow-through nature of a partnership for tax purposes. Under the law that existed prior to the Tax Reform Act of 1986, the partnership vehicle provided partners with the ability to apply their prorata share of tax losses from the partnership investment against other income on their individual tax return and to pay only a single tax on any taxable income of the partnership. After tax reform, which repealed tax incentives for real estate, the most popular investment vehicle for rental real estate remains the partnership, due to the existence not only of only a single tax on partnership income, but also in response to the new rules imposed on real estate investments by tax reform.

In recent years, a new, larger publicly-offered, partnership having Listed Securities called the Master Limited Partnership (MLP) as defined above has been utilized to attract investment in a wide range of activities, including oil and gas, real estate, and other investments. MLPs provide the opportunity for diversification of investments to middle-income, smaller investors who have previously been denied access to the breadth of investment possibilities available to wealthier investors. MLPs are to be contrasted with other limited partnerships (including publicly offered partnerships), that do not have Listed Securities. MLPs began to be used in late 1984 and have grown in popularity in the last few years. The reasons for the surge in MLP activity vary with the nature of the industry and the type of investment involved. In the case of investment real estate, the MLP has gained prominence as a means of attracting equity capital to acquire, or construct, large residential and commercial facilities that otherwise would be beyond the reach of the middle-income investor.

A second major reason for the development of MLPs is to use the equity capital provided by investors to reduce or retire the outstanding indebtedness on existing partnership properties or to acquire unleveraged or low-leveraged real estate. Use of the MLP to acquire rental real estate with less leverage or to retire existing indebtedness on rental properties is in direct response to the anti-debt policy of the Tax Reform Act of 1986. Of particular importance is the fact that MLPs that own rental real estate do not pose a threat to the corporate revenue base. Whether or not the partnership is an MLP that represents a roll-up or a consolidation of existing rental properties or the acquisition of new properties, rental real estate was previously and currently is owned by limited partnerships in the vast majority of group investment situations.

Moreover, the use of investors' equity capital to buy new properties without leverage or with low leverage or to reduce the outstanding indebtedness on partnership properties in real estate MLPs allows the investor to obtain a higher yield by improving the cash flow of the partnership through reduced debt service. In the present investment climate, industry officials believe that a 10% to 12% annual yield is necessary to compete with alternative forms of investment and that such a return cannot be attained without significant debt reduction or retirement. Typically, real estate investments without the tax incentives of prior law and with substantial indebtedness on the properties would have achieved an initial yield of 6%, which would make them uncompetitive with mutual funds and equity stocks in the current marketplace. Additionally, the reduction or retirement of outstanding indebtedness on rental real estate, which MLPs tend to enhance, has the salutary effect of reducing the exposure to financial institutions of troubled loans through the modification of 95% leveraged loans to 80% or less. Thus, not only does the retirement of debt on existing partnership properties through the use of MLPs serve to make real estate competitive with alternative investment choices, but these actions are also consistent with the legislative intent behind the adoption by Congress of the investment interest revisions and the passive loss limitation, which were designed to discourage debt-financed purchases of property.

A number of press reports during the past several months have attributed the growth of MLPs to the need that many investors have for large amounts of passive income to offset unused passive losses under the new passive loss limitation. While this explanation may hold true in a limited number of cases, its importance to the growth of real estate MLPs is greatly overstated. The offering materials for real estate MLPs sold during the last 12 months contain strongly worded caveats cautioning prospective investors that either Treasury regulation or legislative action may recharacterize or reclassify the income from MLPs not as passive income, but rather as investment income that cannot be offset by passive losses. The primary reason for the growth of real estate MLPs lies in the relatively high yields that they are offering investors. Current yields from real estate MLPs have frequently ranged between 10 to 12 percent, which makes them competitive with other investment choices available to today's investor. Moreover, the growth in MLPs would appear to be entirely consistent with the intent of Congress in encouraging economically-oriented transactions while eliminating tax-motivated deals through adoption of the passive loss limitation. In short, MLPs are not designed to produce tax losses, but instead are structured to generate substantial cash flow for investors.

As Congress approaches the issue of how to address the tax treatment of MLPs, the important point to reiterate is that real estate is not seeking to avoid the corporate income tax through the use of MLPs. Real estate has rarely chosen the corporate form of ownership, either before or after tax reform. While industries other than real estate may choose the MLP as a means of converting income distributions to the shareholders or bondholders from portfolio income, such as dividends and interest, into passive income by reliance on a statutory provision that deems all income from a limited partnership to be passive income (subject to Treasury regulations), this statement does not extend to real estate MLPs.

Not only have rental real estate and mortgage loans on rental real estate traditionally operated in partnership form, but the statute specifically defines rental real estate to be a passive activity that generates passive income, irrespective of whether the property is held by a sole proprietor, an investor, or partnership. Accordingly, the creation of real estate MLPs to produce cash flow characterized as passive income is not a subversion of the statutory intent behind the passive loss provision, which was to treat rental income as passive regardless of the form in which the property is owned. The use of a limited partnership or MLP to invest in rental real estate should not alter that result, when any trade or business income from a limited partnership is generally treated as passive income by statute.

Finally, there have been comments appearing in recent tax publications alluding to the administrative problems arising from the operation of an MLP. As a member of Peat, Marwick, Main & Co., with practical, ongoing experience in the area of limited partnerships and MLPs, I believe that the problems of administration attributed to MLPs are exaggerated. Most Big Eight Accounting firms have developed programs and internal systems that adequately address the recordkeeping concerns and compliance problems of administering an MLP. Moreover, the nominee reporting rules contained in the 1986 Tax Reform Act address many of the concerns regarding tax compliance and administration of MLPs. In short, Congress should not take action restricting MLPs in an effort to combat a problem that has already been reduced to manageable proportions.

B. Although RESSI and the National Association of Realtors firmly believe that the present law tax treatment of MLPs should be maintained, we feel even more strongly that any proposal adopted by Congress should not apply to limited partnerships that do not have Listed Securities. The reasons for this position are listed below:

First, if the Congress decides to tax MLPs as corporations because the interests of MLPs are Listed Securities, this rationale does not apply to interests in limited partnerships that do not have Listed Securities. Interests in limited partnerships that do not have Listed Securities are not liquid and are subject to numerous restrictions on their transferability. In 1986, for example, less than one percent of the units in public or non-public limited partnerships, which do not have Listed Securities, were sold for value. In many cases, a limited partner who wishes to sell his interest in a partnership must obtain the consent of and grant the right of first refusal to the general partner. Moreover, often a transferee must meet an original investor's suitability requirements and/or obtain regulatory approval. In short, an investment in a publicly-registered limited partnership contrasts sharply with an interest in an MLP based on the liquidity or lack thereof of the investment.

Secondly, imposition of a corporate tax on publicly-registered limited partnerships would reduce the yield from investments to such a degree that use of the partnership as an investment vehicle would be inappropriate in most instances. Yet, the limited partnership is the only investment vehicle currently available under our present tax system with sufficient flexibility to attract investor capital, especially middle income investors, in the post-tax reform era. A recent article in the Wall Street Journal (June 11, 1987) correctly observed that public partnerships are presently being offered in small denominations, such as $1,000, in order to attract middle income investor capital to the market. Many investors have annual incomes as low as $25,000. The article further points out that the real estate acquisitions being made by such partnerships are of a low-risk, low-leveraged variety, because middle-income investors cannot afford to take undue risks. Once again, the growth of real estate limited partnerships that offer the small investor the opportunity to obtain a high yield from an investment realizes the goal of Congress in the 1986 Tax Reform Act to encourage economically-sound transactions. Furthermore, such partnerships offer the investor the ability to invest in major projects, such as apartments, shopping centers, hotels, commercial office buildings, resort communities, and other real estate investments of a magnitude that would be unavailable to the investor without group investment. In addition, the article observed that non-public, private placement offerings which are generally offered to wealthy investors in real estate have declined precipitously since passage of the tax reform bill. Private placement offerings tended to be those that provided investors with substantial tax benefits which are no longer available after tax reform. Specifically, The Stanger Report projects total private partnerships sales of roughly $1.5 billion for all of 1987, which is a substantial decline from the $3.5 billion in private placement capital raised in 1986.

C. The Partnership is the Sole Investment Vehicle with the Flexibility to Meet the Diverse Needs of Real Estate Investors, Developers, Lenders, and Borrowers.

Flexibility has always been the hallmark of the partnership as an investment vehicle that distinguished it from other forms of investment. The partnership as an investment vehicle provides optimal flexibility to meet the diverse needs of a wide range of investors in a sophisticated real estate market. To illustrate, in a typical real estate transaction, a priority distribution of a specified amount can be provided to a person or entity contributing substantial capital to the development of a real estate project, while another investor can receive a higher percentage of cash flow remaining in excess of the priority distribution. A permanent lender may receive a percentage of the economic appreciation on the sale of the property. The general partner may receive a percentage of the economic appreciation on the sale of the project subordinated to a specified return to investors and may also receive a different percentage of the cash flow during the operation of the property. These allocations are also important for economic, non-tax reasons, because they provide a means for incentive compensation to developers and others active in the real estate business. This degree of flexibility is unattainable with any other alternative form of investment vehicle.

What this example illustrates is that neither a corporation nor a REIT can vary the percentage of ownership for each equity owner in different items of income, loss, gain, and cash distributions while a partnership possesses the ability to alter allocations of income, loss, gain, and cash distributions, to meet the needs of various participants to a real estate transaction. While special allocations of income and loss have tax ramifications that produce different tax results for various partners to a partnership transaction, the recently finalized regulations under Section 704(b) mandate that such allocations must have substantial economic effect if they are to be recognized for tax purposes. Consequently, the potential for abuse of the tax laws under the special allocation provisions of the Federal income tax laws are negated to a large degree. The important point to emphasize is that special allocations are utilized in a partnership agreement, especially in the post-tax reform era, primarily to meet the business needs of the parties and not to achieve tax objectives.

D. Imposition of a corporate tax on real estate limited partnerships that do not have Listed Securities would discourage group investment in rental real estate by drastically reducing the yield from such investments.

Information furnished by the industry indicates that partnerships specializing in real estate have prospered during 1987, because the real estate industry responded to the impact of tax reform by structuring transactions to meet the needs of today's investors. Real estate limited partnerships are raising equity capital from investors to acquire additional properties or to retire or reduce existing debt. Thus, real estate offerings have moved away from the traditional use of leveraging and high debt financing to a market in which equity capital or low leverage furnishes much of the resources necessary to finance the development or acquisition of rental properties. Moreover, continuing the trend that began after passage of the 1984 tax bill, the real estate industry has offered the investor, through use of the real estate limited partnership, a viable entity that provides the potential for significant cash flow and economic appreciation by reducing the debt service on existing properties and financing the purchase and construction of new properties. By the attraction of investor equity or low leveraged capital, as well as through a reduction of various fees charged by the promoter and syndicator, the real estate industry has been able in recent years to provide more attractive yields to investors on rental real estate investments, which make real estate competitive in the marketplace with alternative choices.

However, imposition of a corporate tax on the cash flow of a real estate investment from a limited partnership that does not have Listed Securities would reduce the yield from the investment to such a degree that a real estate investment would no longer be competitive with other investment possibilities. This is especially true for retirement plans which represent a growing segment of the real estate investment market. Statistically, the share of equity capital provided by retirement plans, especially small retirement plans, has risen at an increasing rate over the last several years. Because such plans, such as pension funds, are tax-exempt entities, investments by pension managers are made on the basis of annual yield and economic appreciation and not because of tax incentives. In 1986, more than 60% of the $8.4 billion raised in equity capital through public offerings of real estate limited partnerships, was funded by retirement plans, whereas the percentage of equity capital furnished by such plans in 1982 was only 50%.

An even more positive development for the real estate investment market in recent years has been the tendency of retirement plans, especially the smaller plans, to diversify their investment portfolios by placing a higher percentage of their assets in real estate. Previously, asset managers for retirement plans generally followed a conservative investment policy that directed plan assets primarily into stocks and bonds. ERISA encourages retirement plans to diversify their assets, which should appropriately include investments in real estate. The group real estate investment industry has created limited partnership investment opportunities to enable retirement plans to invest in real estate. Recent studies have shown that a more diversified investment plan for retirement plans, including a higher percentage of investment in real estate assets, would have produced a significantly higher yield for retirement beneficiaries than their actual investment decisions produced. For example, during the eleven year period from 1972 through 1982, the financial return for real estate investments was 11% in comparison to 7.7% for common stocks. The yield to retirees and pension beneficiaries would have increased to 8.5% from 7.7% if the institutional managers of pension funds had invested 20% of their assets in real estate and only 80% in common stock as opposed to the actual percentage of only 3% or less invested in real estate during that same period.

However, the current trend for retirement plans, especially smaller plans, to invest more resources in limited partnerships that do not have Listed Securities would quickly be reversed if a corporate tax is levied on the income of such partnerships. If that eventuality were to occur, payment of the corporate tax would consume too much of the cash flow from the real estate investments made through the partnership to allow such investments to be competitive with alternative choices available to individual retirement accounts or pension managers for retirement plans, whose primary responsibility is to achieve a yield sufficient to meet the retirement income needs of their beneficiaries. In fact, many pension managers would eschew investments in real estate limited partnerships that were reclassified as corporations for tax purposes simply because the corporate tax was imposed, irrespective of the economics of the transaction or the amount of the tax. Thus, the movement by pension managers towards diversification of the investment portfolio would be brought to a screeching halt, which would be to the detriment of the overall yield attained by retirement income beneficiaries and to the further dismay of the real estate industry. Moreover, not only would the yield from real estate investments made by limited partnerships be drastically lowered by reason of the imposition of a corporate tax, but the economic appreciation of interests in real estate limited partnerships that do not have Listed Securities would be reduced by reason of the lower income stream available to investors.

E. If the Congress decides to adopt a model pass-through entity for all types of investments, in lieu of all existing pass-through entities, including the limited partnership, then the model pass-through entity must contain the flexibility which partnerships possess under current law.

During its consideration of the proper tax treatment to be accorded pass-through entities under the federal income tax system, if the Congress decides to consolidate all pass-through entities, including limited partnerships, RICs, REITs, and REMICs, into a single, model pass-through entity that more closely resembles a REIT than any other flow-through vehicle, then we would recommend that such an entity be granted the flexibility which the partnership possesses and which the other investment vehicles, the REIT, the corporation, and the S corporation, lack.

Under present law, a partnership agreement can be drafted with the flexibility necessary to meet the individual needs of particular partners. The flexibility to adopt these features is not present under existing law in either a REIT, a RIC, a REMIC, an S corporation, or an ordinary corporation. In order to make the REIT a more attractive vehicle for real estate investment, substantial revisions are required to the rules governing both the qualification of REITs and the investment of REIT assets in addition to the changes made to the REIT rules in the 1986 Tax Reform Act. If additional changes are made to the REIT provisions allowing for this flexibility, then such a hypothetical REIT would approximate the tax treatment of limited partnerships after tax reform, which limits the deductions from passive activities to the income from such investments. Certainly, one change that should be immediately adopted is to treat the income distributed by a REIT as passive income instead of as portfolio income which is presently the case. This revision would merely conform the character of income from a REIT to that of income from a limited partnership owning rental real estate. However, if these changes are not made, then the REIT as an investment vehicle is too inflexible to attract anything but a small percentage of the total investment capital currently invested in rental real estate. In the absence of a viable investment vehicle to meet the needs of today's real estate investor, the implications for the real estate industry would be ominous.

Even more significant revisions would be required to cause the corporation to be an attractive investment vehicle for rental real estate. Apart from the adverse feature of double taxation, the corporation can only offer common or preferred stock to its shareholders or debentures to its lenders. A corporation does not possess the flexibility to provide different shareholders with varying percentages in different layers of income and loss associated with corporate assets. If the S Corporation is chosen to be a candidate for a model pass-through entity, then its rules must also be substantially revised. These revisions would be in addition to the changes made in the 1982 legislation regarding S Corporations. Current rules allowing S corporation status only where a corporation has 35 or fewer shareholders must be relaxed. Additional revisions that would be required to make S Corporations a suitable vehicle for real estate investment include revisions to the basis rules governing the basis that a shareholder in an S Corporation has in his stock and the rules must also be overhauled regarding the percentage of passive income that an S Corporation can have without disqualification. A further drawback to the use of an S corporation as an alternative to a limited partnership for real estate investment is the fact that many states, including California, do not recognize the existence of an S corporation under their state income tax laws. In those states, the effect is that the income of the S corporation is subject to the state corporate income tax, which substantially reduces the yield in those states.

F. Comments on Suggested Revisions to the Entity Classification Rules

Recently, there have been a number of proposals to revise the rules governing the appropriate classification of an entity, including a limited partnership, under the Federal Income tax laws.

Under Treasury Regulations, (Section 301.7701-3), partnerships are distinguished from corporations by determining whether four corporate characteristics apply to the entity in question. These corporate characteristics are continuity of life, centralized management, limited liability, and free transferability of interests. Under these rules, an entity is taxed as a partnership for tax purposes if it possesses no more than two of these attributes absent other factors indicating corporate classification. If an entity possesses more than two of these characteristics, it is taxed as a corporation.

In one such article, it was suggested that the entity classification rules be revised to include only one criterion, which would require an entity to pass a vastly expanded test of unlimited liability in order to warrant classification as a partnership for tax purposes. These suggested revisions to the characteristic of limited liability would cause an entity to be taxed as a corporation, whether or not the business was conducted in partnership form, if either the partnership did not have general partners with a net worth (excluding the value of partnership property) at least equal to the outstanding liabilities of the partnership or if less than a substantial amount of the partnership liabilities are not on a recourse basis for which a partner(s) has personal liability. If both tests are met, the entity would be taxed as a partnership, but only the general partners with exposure to liability would be allocated the tax losses of the partnership.

This approach, if implemented, would cause serious disruption to investment real estate and would raise more questions than it answers.

First, if the general partner must have a net worth at least equal to the amount of partnership liabilities without taking into account the value of the underlying collateral, then virtually no real estate partnership would be taxed as a partnership. Few, if any, general partners in real estate developments have sufficient net worth to equal the amount of outstanding partnership debt without regard to the value of partnership property. Moreover, it is inequitable to assume that the partnership assets have no value in determining whether one or more partners have a net worth adequate to cover partnership debt. In addition, if the net worth of one or more partners must equal the amount of debt incurred by a partnership owning rental real estate in order for the partnership to avoid the corporate tax, then why should such a test be applied only to partnerships? Would such a test also require individual owners to have a net worth equal to the amount of debt on the rental property to avoid corporate taxation without including the value of the property?

Secondly, even if one or more general partners has a net worth equal to partnership liabilities excluding the value of partnership property, the proposed test would tax the partnership as a corporation if more than an insubstantial amount of the partnership debt were nonrecourse in nature. Such an approach would cause a drastic overhaul of the prevailing use by lenders of nonrecourse financing on both residential and nonresidential rental properties. In the typical situation, a construction loan for the development of rental real estate will be a recourse loan for the simple reason that collateral does not exist to reassure lenders until construction is completed. When the structure is placed in service, the permanent lender provides a nonrecourse loan to take out the construction lender and secure repayment of the loan with the property. It should be noted that lenders who arrange nonrecourse loans do not do so to further the tax objectives of the borrower, but because they have collateral in the structure that equals or exceeds the outstanding debt owed them by the borrower. Moreover, many states, including California, mandate the use of nonrecourse financing in a number of real estate transactions. Furthermore, the question must be asked, if the presence of a significant amount of nonrecourse indebtedness on partnership property causes the partnership to be taxed as a corporation, why should this test not also be applied to individual owners of rental property, causing them to be subject to the corporate tax, if their property is financed with a nonrecourse loan.

And finally, the proposal would require partnership tax losses to be allocated exclusively to those partners with unlimited liability even if the net worth and recourse liability tests were met. This aspect of the proposal would require a substantial rewriting of the special allocation provisions of Section 704(b) of present law. Treasury regulations, which were recently finalized under Section 704(b), require substantial economic effort in order for allocations of income and loss that are contrary to the general profit and loss ratio to be respected for tax purposes. Most tax experts believe that the final regulations address the potential abuses of noneconomic, tax-motivated allocations under prior law. Also, the proposal only suggests that tax losses be allocated to partners bearing the risk of loss, but does not discuss the allocation of income. Would income follow loss allocations for tax purposes or would it be allocated under a different formula? Moreover, such a proposal would be contrary to the widely accepted view reflected in the 704(b) regulations that those investors who may lose capital in a transaction should be entitled to a deductible loss from their economic investments.

CONCLUSION

To summarize, both RESSI and the NATIONAL ASSOCIATION OF REALTORS® strongly believe that the present entity classification rules should not be changed and that the current tax treatment of partnerships, including MLPs, should be maintained. The Tax Reform Act of 1986, which repealed or greatly curtailed tax incentives for real estate investment, has adequately addressed any perceived tax abuses. Revisions to the entity classification rules are unnecessary and would be a case of overkill at a time when the real estate industry is adapting to the effects of tax reform.

If Congress is of a different view, we urge you to target the perceived abuses only and not to adopt a sweeping proposal that could have devastating effects on the real estate industry, which already is in a period of transition after tax reform. RESSI and the NATIONAL ASSOCIATION OF REALTORS® stand ready to work with the tax-writing Committees of Congress in drafting appropriate legislation, or to answer any questions that you may have.

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RESPONSES TO TREASURY DEPARTMENT ASSERTIONS RELATING TO MASTER LIMITED PARTNERSHIPS

In his testimony before the House Ways and Means Subcommittee on Select Revenue Measures and the Senate Finance Subcommittee on Taxation and Debt Management, Assistant Treasury Secretary J. Roger Mentz advocated on behalf of the Treasury Department that Congress enact legislation treating publicly traded master limited partnerships (MLPs) as corporations for tax purposes. In support of this policy, Mentz offered a series of arguments which were, to a disturbing extent, based on incorrect assumptions and a general lack of understanding of MLPs and their role in the marketplace.

It is important that both policymakers and the general public understand the real facts behind Mentz' assertions. This paper will compare Mentz' statements, taken in the order in which they appear in his testimony, with more complete and reliable information about MLPs. The material in the paper is derived for the most part from the letter of Edward C. Oelsner III of Dean Witter Reynolds to Assistant Secretary Mentz, dated July 16, 1987, and from the testimony of Andrews & Kurth before the Finance Subcommittee on Taxation and Debt Management.

I. Tax Reform Changes

Assertion

The Tax Reform Act of 1986 (TRA) significantly increased the incentive to conduct business through partnership form by making the corporate rate higher than the individual rate, enacting passive loss rules making MLPs attractive as a source of passive income to offset passive losses, and other provisions making corporate taxation more severe. Table 1 in the testimony shows that this incentive has doubled over that in pre-1986 law.

Table 1

Percentage Increase in the After-Tax
Rate of Return to an Investor Conducting
Business in Partnership Rather Than Corporate Form[1]

Asset	Relative After-Tax Return[2] Prior Law	TRA
Equipment	6.9	18.7
Structures	10.0	22.6
Inventory	15.6	23.7
Land	15.6	23.7
Overall	10.8	21.7

Department of the Treasury June 29, 1987
Office of Tax Analysis

[1] Calculations assume a real 8 percent pre-tax return on all investments, a 4 percent inflation rate, and include the effects of cost recovery allowances and statutory income tax rates at the Federal and state levels. Financing is two-thirds equity and one-third debt. Most of the return to corporate equity (93 percent) is taxed as a capital gain, with the remainder (7 percent) of the return to corporate equity taxed as a dividend.

2

2 Difference between the noncorporate after-tax return and the corporate after tax return, expressed as a percentage of the corporate after tax return.

Fact

Even assuming that the figures in Table 1 are correct, it is highly misleading. What they really say is that an investor's yield of 10% in corporate form would have been 11.08% (10 plus 10.8% of 10) in partnership form before TRA, while it would be 12.17% (10 plus 21.7% of 10) after TRA. Thus, although the increase in yield has been doubled, the yield itself has increased by only 1.09 percentage points--hardly a sufficient change to cause a rush into the partnership form.

Furthermore, it is quite possible that the figures in Table 1 are not correct. There are many ways of measuring the effect of corporate level taxation on an investor's rate of return. All of them are of necessity highly simplified, since the corporate tax is only one of many factors affecting the return on investment, and all require assumptions that may or may not be true. At least one of the assumptions in Treasury's Table 1--that the financing ratio for corporate investment would be two-thirds equity to one-third debt--is almost certainly erroneous. Any reasonably knowledgeable observer of our highly leveraged corporate economy knows that the ratio is more likely the reverse.

Another, extremely simple way of analyzing the difference in yield between corporate form and partnership form is to look at a dollar of earnings that is fully distributed to investors. Here we find that the increase in the differential due to TRA is small, only 1.48 cents per dollar.

After-Tax Return Per Dollar of Earnings

	Prior Law		TRA	
	Corporation	Partnership	Corporation	Partnership
Pre-tax earnings	$1.00	$1.00	$1.00	$1.00
Corporate tax	.46	.00	.34	.00
After-tax income of entity	.54	1.00	.66	1.00
Partner-level tax	.00	.50	.00	.28
After-tax earnings	.54	.50	.66	.72
Tax on distributions	.27	.00	.1848	.00
After-tax cash flow to investors	.27	.50	.4752	.72
Differential	.23			.2448

Increase in differential = .0148 or 1.48 cents

This penny and a half difference is hardly sufficient to alter taxpayer behavior. Still another method of analyzing the differential is to look at a fully reinvested dollar. While the previous analysis oversimplified by assuming that all after-tax corporate earnings would be distributed to shareholders, this method oversimplifies by assuming that all corporate earnings are retained and reinvested after the corporate level tax is paid, rather than paid out as a dividend. When this happens, the value on the retained earnings is ultimately realized at the shareholders' capital gains rate (when they sell their stock, its value has been increased by the amount of retained earnings). Under this assumption there is a greater increase in the differential, from 6.8 cents to 24.48 cents, a difference of 17.68 cents. This is mostly due to the repeal of the capital gains preference.

	Prior Law		TRA	
	Corporation	Partnership	Corporation	Partnership
Pre-tax earnings	1.00	1.00	1.00	1.00
Corporate tax	.46	.00	.34	.00
After-tax income of entity	.54	1.00	.66	1.00
Partner-level tax	.00	.50	.00	.28
After-tax earnings	.54	.50	.66	.72
Tax on value realized by investor	.108	.00	.1848	.00
After-tax return to investor	.432	.50	.4752	.72
Differential	.068		.2448	

Increase in differential = .1768, or 17.68 cents

If nothing else, this shows that analyses of the true effect of the entity level tax and of changes in rates will vary widely depending on the assumptions used and whether you look at the actual rates of return, the differential, or the increase in the differential. All such analyses which are based on maximum tax rates, including Treasury's, ignore the fact that the rates actually paid by corporations (effective rates) are often much lower due to such practices as debt leveraging. Mentz himself admits, "The effect of these rate reductions is difficult to determine, however, since the effective, rather than the statutory tax rate on a partnership's or corporation's income varies with its particular activities."

To assume that the rate differential will in itself lure many businesses into MLPs also ignores the many disincentives to the partnership form that apply to MLPs and that were not changed by TRA. Primary among these are the inability of MLPs to retain a significant amount of earnings, due to the market pressure to distribute most of their cash flow to investors, and their lack of access to institutional investors due to the fact that the latter would have to pay tax on partnership earnings as unrelated business taxable income (UBTI).

In fact, none of the post-TRA MLP issues of which we are aware was motivated by the tax law changes. Nor are MLPs being marketed as generators of passive income with which to soak up otherwise non-deductible losses. In a typical MLP whose cash distributions are one-third taxable, an taxpayer would have to invest $1.5 million to offset $50,000 in losses.

II. Existing MLPs and Future Trends

A. Background

Assertion

A fifth category of MLP, the "start-up MLP," may well predominate in the future--that is, new businesses will form as partnerships rather than corporations.

Fact

There have in fact been very few "start-up" MLPs to date, perhaps three (Arthur Andersen estimates nine "initial public offerings," but includes in this number first-time public offerings for the purpose of expanding an existing business as well as those used to bring a new business idea to fruition). There is little reason to believe that their numbers will dramatically increase. Those that have occurred have been in industries, primarily real estate, that have always used the partnership form of doing business. In most cases, the needs of a new business will dictate against using the MLP form. New businesses need to be able to reinvest their earnings, while MLPs must distribute most of their earnings to investors. New businesses need access to the public capital market, while MLPs are greatly restricted due to their inability to attract the institutional investors who dominate that market. Few business managers will accept these restraints.

B. Existing MLPs

Assertion

Currently there are 126 MLPs publicly trading or in the process of formation. This represents a rapid rate of growth since the formation of the first MLP in 1981, and the rate of growth is accelerating.

Fact

Estimates vary as to how many MLPs are currently publicly traded; but no analyst has estimated more than 100. The rest of the 126 cited by Treasury are MLPs that are in formation. Judging from past history, at least some of these will never reach the public trading stage. Many companies that have explored the formation of an MLP have changed their minds when they have realized the inconvenience, expense, and many disadvantages involved.

The initial percentage growth of any phenomenon from zero to a larger number always appears impressive. An increase from one to two is a 100% increase. That does not mean that that growth rate will continue into the future; in fact the likelihood is that it will not. As for any acceleration due to TRA, the average rate of formation of MLPs in the 18 months prior to enactment was 3 per month. The average since enactment has been 4 per month--hardly a startling acceleration.

Assertion

Contrary to the claims of supporters of MLPs that their use would be limited to businesses engaged in passive activities, many of the MLPs formed recently have been in active businesses that have traditionally operated in corporate form, including sports franchises, cable television, gas pipeline, motion pictures, hotel and motel chains, health care business, restaurant chains, and homebuilders.

Also contrary to supporters' assertions, these MLPs are not limited to businesses distributing most of their income, and they are capitalized in large part by debt. Mentz' testimony lists examples of several recent MLPs that are alleged to prove these points.

Fact

Mentz has misunderstood the arguments of MLP supporters. It was never claimed that MLPs would be limited to "passive businesses"--every business, including natural resources and real estate, has some very active components. Rather, it was stated that only businesses that generate substantial cash flow and are free of significant reinvestment requirements would be conducive to operating in MLP form.

Most of the "active" businesses which Mentz has cited--and there are still only a few MLPs in each of these--have always used partnerships or other pass-through entities to some extent. Some of the corporate liquidations were from Subchapter S corporations and therefore simply an exchange of a closely held pass-through entity for one that is widely held. With the exception of some corporate liquidations that have retained their old distribution patterns, most MLPs do in fact pay out most of their cash flow to unitholders.

While MLPs do have some debt financing, it is far less than the amount of debt financing incurred by corporations. It is rare for an MLP to have more than a 50-50 debt to equity ratio, and most have far less. Corporations commonly have as much as a 4-1 debt-equity ratio. Those

MLPs with a 50% debt level are typically "acquisition" MLPs which sometimes are formed to acquire corporate assets as an alternative to a leveraged buyout. A leveraged buyout, by contrast, typically has a 90-10 or even 95-5 debt-equity ratio.

A look at the facts behind Mentz' six examples reveals both inaccuracies and a misunderstanding of the transactions involved:

1. **Example:** A professional sports team, operating in corporate form, proposed to roll out its sports franchise operations into an MLP.

The facts: The sports team to which Mentz refers is the Denver Nuggets, a prospective MLP which in fact never made it to the market. One reason may have been the record of its predecessor, the Boston Celtics MLP, a widely reported liquidation, which is currently trading at a price far below its initial offering price. Professional sports teams tend to have widely fluctuating revenues, while MLPs are more suitable for businesses with a predictable cash flow. The market has realized this; and it is likely that the Celtics will remain the only sports franchise to take this route. Incidentally, the Celtics team was previously owned by three investors in a Subchapter S corporation, a common form of business for sports franchises, and thus was paying no corporate tax.

2. **Example:** A homebuilding corporation liquidated into an MLP, then acquired another homebuilding corporation in a two-stage leveraged buyout funded largely by bank loans and debt securities.

The facts: The corporate homebuilder, NVHomes, also liquidated from a pass-through corporation, and there was thus no loss of corporate tax revenue. Homebuilding has often been conducted through pass-through entities. NVHomes made an initial MLP offering in November 1986. The only other financing alternative considered at that time was debt. A combined debt-equity offering was made in June 1987. The June offerings were used to pay down debt incurred in the purchase of Ryan Homes. The market did not respond well to the 1987 offering, and it had to be reduced by $40 million from the initial filing. In fact, the market is the best limit on MLP debt, as investors will be wary of any debt load that will hamper the MLP's ability to pay a substantial cash yield. The takeover of Ryan Homes, incidentally, was friendly--it is difficult, if not impossible, to use MLP equity to accomplish a hostile takeover.

3. **Example:** The business of a corporation that had been acquired in a leveraged buyout was converted to partnership form by having the acquired corporation contribute its business to a partnership, in exchange for a $100 million note and $100 million in partnership interests. The partnership then sold its interests to the public, becoming an MLP, and used the proceeds to retire its debt to the sponsor, who presumably used them to retire its acquisition indebtedness. The MLP's prospectus promised cash distributions approximately equal to the partners' tax liability.

The facts: This example, which refers to the sale to Shearson Lehman Brothers Holding Inc., and ultimate placement into an MLP, of Sun Company's subsidiary Sun Distributors, is a form of acquisition MLP that may be termed a "public buyout." As indicated above, these MLPs, which have about a 50-50 debt-equity ratio, substitute for leveraged buyouts, where the ratio is about 90-10. The proceeds of Sun Distributors' MLP offering were used to pay down Shearson's note to Sun, replacing debt with an approximately 1:1 combination of debt and equity.

While the distribution formulas for the two classes of unitholders are somewhat complex, the upshot is that the unitholders' taxable share of partnership income from operations is well below the stated distribution level.

Sun Distributors is a wholesale distributor of industrial products. This type of business is generally not capital intensive, and much like the natural resource industries, finances its growth through working capital. It thus fits within the parameters of a business suitable for the MLP form.

4. **Example:** In December 1986 a corporation operating over 50 long-term health care centers and 20 home health care programs liquidated into an MLP. The distribution policy will be to distribute annually to partners an amount equal to the tax savings from operating in MLP form.

The facts: The health care corporation referred to is National Healthcorp, L.P. National Healthcorp is one of several corporations that rushed to liquidate at the end of 1986 in order to beat the impending repeal of the General Utilities doctrine under TRA (the General Utilities doctrine allowed a corporation to distribute its assets upon liquidation without being taxed. The repeal means that the liquidating corporation will be taxed as if it had sold its assets for fair market value, and the shareholders will recognize capital gain). The distribution policy is to pay out 60% of taxable income. The repeal of General Utilities, now in effect, has effectively ended corporate liquidations into MLPs; thus National Healthcorp is not a relevant example for future policy.

5. **Example:** An MLP with approximately 3,500 employees was formed early this year by rolling out the natural gas processing, transportation, storage and distribution business of the sponsor. The sponsor retained a 40% interest in the MLP. The MLP assumed $130 million in debt, representing about 25% of the net value of the business, and will distribute all its net cash flow, financing acquisition through borrowing and new MLP issues.

The facts: The MLP to which Mentz refers is Petrolane Partners, L.P., a roll-out of the LP gas business of Texas Eastern. Based on our knowledge of the Petrolane transaction, we can state that Mentz' assertions regarding Petrolane are misleading and contain several factual errors.

6. **Example:** A similar transaction considered in March 1987 involved the purchase of a natural gas pipeline from the corporate sponsor, with 30% of financing coming from the sale of MLP units and 70% from debt.

The facts: The second pipeline example, like the Denver Nuggets, is an MLP that never was created. This may be because the market would have been unlikely to accept the anticipated debt to equity ratio.

When the facts are understood, Mentz' examples substantiate the arguments of MLP supporters that (with the possible exception of a few liquidations which will no longer occur): 1) MLPs will be suitable only for businesses which are not capital intensive and have a predictable cash flow; 2) MLPs will pay out most of their cash flow to investors--and indeed will suffer in the marketplace if they do not; and 3) MLPs are used to substitute for and retire corporate debt, and carry far less debt themselves than do corporations.

III. Policy Considerations

A. Advantages of the MLP Form

Assertion

Formation of MLPs is motivated primarily by the desire to avoid corporate taxation. The non-tax considerations cited by MLP supporters--raising capital without incurring debt, retiring debt, highlighting the value of undervalued assets, and more efficient management and investment practices--are all attributable to the fact that MLPs are taxed at a single level while corporations are double taxed. For example, MLPs substitute for corporate debt because both are taxed at a single level.

Fact

Any time a business decides whether and how to raise, borrow, expend, invest, lend, or distribute money, its analysis will include consideration of the tax ramifications of the decision.

Tax considerations are one factor that is weighed in the overall balance. This does not mean they are the primary factor. With the exception of a few corporate liquidations, every MLP formation was motivated by legitimate, non-tax, business purposes.

Indeed, the MLPs that have been "roll-ups" of several non-traded partnerships could not possibly have been formed to escape corporate taxation--no corporate tax was being imposed on the component entities. Mentz' argument also ignores the fact that in most roll-outs a good deal of corporate tax continues to be paid because the corporate sponsor retains a large interest--over 95% in some cases--of the MLP and pays corporate tax on the resulting income. Freeport McMoRan found that its estimated federal corporate tax liability has actually increased by 50% for 1987 following its 1985 and 1986 roll-outs. As one corporate executive told the Ways and Means subcommittee, "If we were looking for a means of avoiding corporate taxation, this is an awfully inefficient way of doing it."

When he says that MLPs substitute for corporate debt because both are taxed at a single level, Mentz helps make one of our main points. Because MLPs use equity to substitute for debt, and because both are taxed at a single level, MLPs should not have any negative revenue consequence. Indeed, they may even enhance revenue. Corporate debt often is not even taxed at one level, as much of it is held by tax-exempt institutional investors. Virtually all MLP units, on the other hand, are held either by the sponsoring corporation--and thus subject to double taxation--or by taxpaying individuals, thus ensuring at least one level of taxation.

B. Ad-Hoc Integration

Assertion

Because they are used to avoid corporate taxation, MLPs represent a form of "ad hoc integration" through which corporations avail themselves of relief from the corporate tax that has not been authorized by Congress. This creates inequities, because not all corporations have the option of becoming MLPs--existing ones will find it too expensive to liquidate due to the repeal of General Utilities.

For example, [this statement was made in Mentz' oral testimony], General Motors cannot liquidate and form an MLP, but if John DeLorean wanted to start a company to produce a new car, he could start out as an MLP--and any responsible tax lawyer would advise him to do so. This is unfair to GM.

Fact

First of all, Mentz' starting premise is faulty, because as we have seen, MLPs are not formed for the purpose of avoiding corporate taxation. Second, an MLP is a partnership under all the federal and state laws that define partnerships. The choice between assuming the corporate form, with all its privileges, and paying a corporate tax, and assuming the partnership form and receiving pass-through treatment has existed since the tax system began. To say that doing business as an MLP, or as any type of partnership, is an unauthorized, ad-hoc way of achieving integration is thus contrary to history and fact.

The fact is, business managers have chosen the corporate form in overwhelming numbers, and most of them, including GM, don't want integration. GM and its fellow corporations are quite happy to be corporations for the same reason that the hypothetical DeLorean company and most other new businesses would never begin as MLPs: corporate managers do not want to relinquish their ability to retain and reinvest earnings, nor to give up access to the institutional investors that are now the lion's share of the public capital market. This is especially true of capital intensive industries like the auto industry, where it is impossible to succeed without reinvesting a large portion of earnings. Any responsible tax lawyer would advise DeLorean against taking the MLP route.

C. Administrative Considerations

Assertion

MLPs create difficult accounting and tax collection problems. They cannot comply with the rules in Subchapter K and other sections of the tax code applying to partnerships. In their attempts to achieve compliance, MLPs must make a number of simplifying assumptions in order to account for the entity's operations and the partners' activities. These assumptions result in possibly significant inaccuracies. Furthermore, there is concern whether the IRS can verify their accuracy through the audit process and enforce liabilities where inaccuracies are discovered.

While these difficulties can be addressed short of taxing MLPs as corporations—by revision of the constructive termination rules, by sanctioning of current MLP assumptions, by imposing a partnership level withholding tax, and by collecting deficiencies discovered in an audit at the partnership level—the need for such measures indicate that MLPs do not possess the requisite partnership characteristics.

Fact

It is true that tax compliance is a difficult and complex matter for MLPs. However, MLPs and their accountants have developed highly sophisticated computer programs that have resolved these problems to a large extent. Perhaps the biggest problem, that of identifying unitholders whose interests are held in "street name," has been resolved by the passage of Section 6031 of the Tax Reform Act, which requires brokers to report these unitholders to the MLPs. When assumptions must be made, they are invariably made on the conservative side, so that any error will benefit the Treasury.

Since Mentz admits that administrative problems can be solved without taxing MLPs as corporations, why resort to this drastic and disruptive measure? MLPs and their accountants and underwriters stand ready to work with Treasury on solutions to any remaining problems. While imposing a withholding tax on MLPs would be an unacceptable and inequitable burden on one particular form of financing, other measures, such as changes in the Subchapter K rules and partnership level deficiency collection, are certainly worth considering.

As for the notion that administrative problems show that MLPs do not possess the requisite partnership characteristics, it should be remembered that many of these problems are shared by large, non-traded partnerships whose classification has not been questioned. In any case, has anyone ever suggested that some corporations' difficulty in complying with complex corporate tax laws renders them unsuitable to be classified as corporations?

D. The Corporate Tax Base

Assertion

If MLPs are allowed to retain pass-through treatment, there will be rapid growth in the number of MLPs. Despite the costs of forming and operating an MLP, the tax law will increasingly cause businesses entering the public capital markets to utilize the MLP rather than the corporate form. While the revenue consequences of MLPs are relatively modest at present, the long-term revenue effect of allowing MLPs to be taxed as partnerships will be far greater. There will be a serious erosion of the corporate revenue base, leading to a "revenue hemorrhage."

Fact

As has been discussed above, there will not in fact be a proliferation of MLPs if current law is retained. For most businesses the disadvantages of operating in the partnership form far outweigh any tax benefits. Besides the inability to retain earnings and the lack of access to institutional investors, these disadvantages include the lack of unconditional limited liability, particularly at the general partner level; the lack of perpetual existence (MLPs, like other partnerships, are formed for a specified period of years and may be involuntarily terminated upon the occurrence of any of several events); the complexities of administration--which, while manageable are an added expense that must be considered--and the unsettled state of state partnership law as opposed to state corporate law.

Even if MLPs were to form in large numbers, however, there would not be a significant negative impact on federal revenues. To begin with, the formation of an MLP will often provide a one-time revenue windfall due to capital gains and recapture tax.

Over the long term, a roll-up MLP will not lose revenue--its component partnerships were, obviously, paying no corporate tax to begin with. Roll-ups probably increase federal revenues, due to the more frequent trading--with concomitant capital gains recognition and recapture--of previously illiquid partnership interests.

Roll-outs and acquisition MLPs, as we have seen, also will not have much of a revenue effect, because 1) they substitute equity for or retire corporate debt, which in itself is taxed at one level and sometimes not taxed at all, and 2) the corporate general partner often retains a large share of the MLP units and pays corporate tax on income from them.

Start-up MLPs are rare so far and probably will not accelerate significantly. Any revenue effect of their formation would of course be not on the current corporate tax base but on future growth in that base. This effect is likely to be small. For the same reasons that there will not be large numbers of MLPs, any start-up MLPs that are formed will likely be limited to industries that have traditionally operated through pass-through entities. If these start-ups were not able to form as MLPs, they would probably form as non-traded partnerships, Subchapter S corporations, or another pass-through entity.

If revenue is the true concern, there is more to be found in Treasury's proposal that MLP income be classified as portfolio rather than passive--although the logic behind this proposal may be questionable. According to Treasury's revenue estimate, the proposal to tax new MLPs as corporations would raise $665 million over five years (this figure assumes that existing MLPs would be given some sort of grandfathering or transition). From this figure, one must subtract the $260 million attributable to adopting the portfolio income proposal for new MLPs, leaving as the true gain from reclassification $405 million.

If one adopts the figures for reclassification of new MLPs with an exemption for natural resources MLPs, the figure drops to $377 million ($618-$241 million). The proposal to treat income from all MLPs, new and existing, as portfolio (Treasury has existed that there would be no grandfather or transition for this provision) would, by contrast, raise $586 million. Remember also that if MLPs are taxed as corporations, there will be no new MLPs generating income to classify as portfolio, and Treasury would thus lose this source of revenue.

In short, MLPs simply do not pose a threat to the corporate revenue base in either the short or the long term. Adopting Treasury's proposal to tax MLPs as corporations is not a revenue enhancer, nor a revenue protector. In fact, in some circumstances it could be a revenue loser.

IV. Conclusion

It is important to examine another argument, which, although Mentz does not state it explicitly as he did in his 1986 testimony, is an important part of Treasury's case, and that of many other MLP critics. This is what has come to be called the "walks like a duck" argument--i.e., an MLP "walks and talks like a corporation" and thus should be taxed like one.

In fact, an MLP walks and talks like a partnership. The apparent corporate resemblance is based on two criteria, size and public trading, which are poor criteria for distinguishing partnerships from corporations. Less than one percent of all corporations are publicly traded or are as large as MLPs. Similarly, many non-traded partnerships are as large or as larger than MLPs; public trading is the sole distinguishing factor.

In every other respect, MLPs are more like partnerships than corporations, and they are classified as partnerships under state partnership law. Those factors listed as disadvantages to the partnership form and disincentives to MLP formation are also ways in which MLPs are like partnerships and different from corporations. These differences are crucial in both the decision of a business owner as to choice of entity and the decision of an investor as to where to place his or her money. Another difference, which many MLP managers see as an advantage, is that MLP investors have far less control over the general partners than corporate shareholders have over corporate management. Unlike the latter, general partners can only be removed in cases of gross mismanagement.

Assistant Secretary Mentz' statement on behalf of the Treasury Department makes what appears to be an appealing case for ending partnership tax treatment for MLPs. When closely examined, however, this case proves to be built on incorrect assumptions and a serious misunderstanding of what is happening in the real world.

The case for taxing MLPs as corporations simply has not been made. Congress should refrain from changing the tax treatment of this entity.

STATEMENT
OF
SANTA FE PACIFIC EXPLORATION COMPANY
ON THE MATTER OF
MASTER LIMITED PARTNERSHIP TAXATION

Santa Fe Pacific Exploration Company (Santa Fe) as managing general partner for Santa Fe Energy Partners, L.P. (SFP), an oil and gas exploration and production master limited partnership (MLP), appreciates this opportunity to comment on why MLP's should continue to be treated as partnerships for federal income tax purposes.

As background, SFP was formed in late 1985 in a rollout transaction wherein selected properties of Santa Fe Energy Company, the oil and gas operating company of Santa Fe Southern Pacific Corporation (SFSP), were contributed in exchange for limited partnership units. Additionally, a public offering of approximately twenty-two percent of the units was made. Approximately seventy-eight percent of the partnership interests were retained by affiliates of SFSP. The partnership was formed to provide greater access to capital markets and to enhance SFSP stockholder value by highlighting the oil and gas operations of the corporation.

Several reasons for taxing MLP's as corporations have been proposed by the Treasury Department: 1) the general revenue loss to the United States Treasury; 2) avoidance of the passive loss rules enacted in 1986; and 3) Internal Revenue Service administrative problems in collecting taxes from individual partners. Our comments on each of these issues are as follows:

Revenue Effect: Mr. Mentz advanced a proposal to tax MLP's as corporations that would improve revenues by only $665 million over a five-year period; this is not a significant amount when viewed in the context of the federal budget or deficit. With regard to our specific partnership, SFSP companies currently hold an approximately 80% ownership interest. Corporate tax is therefore still paid on 80% of the partnership income. If the primary motivation for establishing SFP had been the avoidance of double taxation of corporation income, a significantly larger percentage of partnership units would have been issued to the public. The decision to do otherwise emphasizes the non-tax business reasons for establishing SFP (i.e., the raising of capital and the enhancement of SFSP shareholder value through increasing public awareness of its oil and gas operations).

Passive Loss Avoidance: Some concern has been noted by Treasury that classification of MLP income as passive income could circumvent the intent of recently enacted passive loss rules. On the other hand, MLP's may also generate losses which would be classified as passive. Should this issue truly be considered significant, it appears that Treasury currently has the authority to correct the matter through Regulations.

Administrative Problems: We do not believe that perceived administrative problems should dictate tax policy. Such problems can be handled much less drastically than by tampering with longstanding classifications that have been relied on by taxpayers and the capital markets for years.

In summary, SFSP has utilized the Master Limited Partnership as a vehicle for raising capital and to spotlight certain assets of our corporation. We firmly believe their tax status should not be altered.

SERVICEMASTER LIMITED PARTNERSHIP

Statement to the Senate Finance Subcommittee on Taxation and Debt Management

On behalf of ServiceMaster Limited Partnership ("ServiceMaster"), I welcome the opportunity to provide testimony to the Senate Finance Subcommittee on Taxation and Debt Management in connection with the Subcommittee proceedings on the tax treatment of master limited partnerships ("MLPs").

My remarks are primarily limited to the issues of changing the tax treatment for existing partnerships that converted from corporate form to partnership form in reliance on current law.

Summary

On December 30, 1986, ServiceMaster's predecessor, ServiceMaster Industries, Inc., converted its entire business from the corporate form of organization to the limited partnership form of organization.

ServiceMaster viewed the conversion to partnership form as advantageous for business and financial reasons. The partnership form more closely reflects the nature of ServiceMaster's business. Partnership form allowed an increase in the amount that senior management had at risk in the success of the business and thus is important in maintaining the dedication necessary in a service business. This risk exposure, as contrasted to corporate limited liability, distinguishes ServiceMaster from a corporation, in form and in substance.

As part of the conversion to partnership form, ServiceMaster Industries, Inc. liquidated under section 331 of the Internal Revenue Code. The liquidation was taxable at both the corporate and shareholder levels. The taxes paid by ServiceMaster and those estimated to have been paid by its shareholders total over $70 million.

ServiceMaster and its shareholders incurred these costs in reliance on existing law regarding the classification of publicly traded partnerships and the repeated rejection by Congress and the Administration over the past five years of proposals to change that classification. Given the legislative record, particularly the rejection of the classification proposals and the repeal of the General Utilities doctrine making further conversions unlikely, ServiceMaster was entitled to believe that its conversion, effected at a substantial cost, would be respected and there would be no change in its tax treatment, especially when this cost accelerated tax revenue to the government and did not defer or lose revenue for the government.

ServiceMaster appreciates the reasons for a change in the passive loss rules to classify income from publicly traded MLPs as portfolio income not shelterable with passive losses and therefore would not have any objection to legislation adopting such an approach.

ServiceMaster is concerned with the impact of any rules restricting the use of debt financing by MLPs on the debt incurred by existing MLPs capitalized under current law. ServiceMaster believes that any such restrictions should not apply to partnerships capitalized before the effective date. In addition, any such restrictions should be applied in a manner that reflects the fair market value of an MLP's equity and that recognizes the cash flow characteristics of the enterprise.

Description of ServiceMaster: Its Business and Management

ServiceMaster is an Illinois-based international service company which manages the housekeeping operations, the plant, maintenance, laundry and material management functions, and the food service operations in over 1,000 hospitals, 350 colleges, universities and school districts, and 100 major industrial facilities.

To obtain and retain its customers, ServiceMaster must establish a relationship of trust and confidence in which the people of ServiceMaster are constantly demonstrating that the customer's business activities under ServiceMaster's management are more effective and productive because of ServiceMaster and the performance of its people. The very personal relationship which develops between the people of ServiceMaster and its customers makes ServiceMaster analogous to personal service companies which have found the partnership form of doing business preferable because it provides for partnership ownership and accountability among those responsible for delivering the service. Indeed, our very name conveys the personal service nature of our business.

Because ServiceMaster's business requires highly motivated manager employees that serve with the heart of an owner, ServiceMaster has attempted over the years to establish a broad base of employee ownership and to instill in its employees the attitude of being a partner in service to the Company's customers. At the present time, over 50% of ServiceMaster's employees participate in ServiceMaster's ownership purchase plan and over 70% of ServiceMaster employees participate as owners through the Company's profit sharing and retirement plan. At the executive level, ServiceMaster's senior managers have made major commitments to the purchase and ownership of equity in ServiceMaster. As a result, these executives do not have diversified portfolios and substantially all of their net worth is at risk in the success and growth of the Company.

ServiceMaster is thus a personal service company in which employee dedication, motivation and close identification with the Company's objectives are central to the Company's business. In the view of ServiceMaster's directors and management, ServiceMaster is a natural partnership and has enhanced its ability to serve its customers by converting to partnership form.

The Reorganization

Prior to December 30, 1987, the ServiceMaster enterprise was operated in a standard corporate form, with a parent company and several subsidiaries. On December 30, 1986, the company converted its entire business into partnership form. This was accomplished through the liquidation of the parent corporation and all of its subsidiaries. A holding partnership (ServiceMaster Limited Partnership) and an operating partnership (The ServiceMaster Company) were formed to receive ServiceMaster's assets and continue its business. Each of the two partnerships was organized as a Delaware limited partnership with a corporate general partner (ServiceMaster Management Company) and four individual general partners. As will be discussed in greater detail below, the reorganization was a fully taxable transaction which generated significant tax liabilities at both the corporate and shareholder levels.

Personal Liability of the General Partners and Certain Other Executives

Four ServiceMaster executives serve as general partners in each of the ServiceMaster partnerships. They are C. William Pollard, President and Chief Executive Officer; Robert D. Erickson, Executive Vice President and Chief Financial Officer; Charles W. Stair, Executive Vice President, Management Services; and Alexander Balc, Jr., Senior Vice President. As a general partner, each of these men has exposed his entire net worth to the risks of ServiceMaster's business. In addition to the unlimited liability of the individual general partners, 15 senior executives of ServiceMaster have exposed substantially all of their personal net worth to the risks of ServiceMaster's business by virtue of their contributions to ServiceMaster Management Company (the corporate general partner) and their status as the shareholders of that corporation.

This unlimited liability on the part of general partners is the most significant attribute of a partnership. The risks assumed by the individual general partners and the shareholders of the corporate general partner clearly differentiate ServiceMaster from a corporation, where top management and large shareholders are not at risk.

The Tax Cost of the ServiceMaster Reorganization

The conversion to partnership form involved a taxable liquidation of the corporations that made up ServiceMaster. The federal income taxes paid by ServiceMaster and those estimated to have been paid by its shareholders as a result of the liquidation total over $70 million.

Stating the tax results of the conversion in the aggregate tends to disguise the tax impact in individual cases. No cash was distributed in the conversion to pay the substantial tax liabilities incurred by the shareholders. Many small shareholders (including employee-shareholders with holdings built up over years of service with ServiceMaster) had to borrow in order to pay tax liabilities which were substantially in excess of their annual cash incomes.

If, despite ServiceMaster's reliance on Congressional decisions (see below), its tax status were now changed and ServiceMaster were taxed as a corporation, the substantial costs of conversion would be forfeited without recovery or benefit, causing large additional losses to ServiceMaster's 25,000 partners, many of whom are its employees.

The Tax History Relied Upon by ServiceMaster

In planning the conversion from corporate form to partnership form, ServiceMaster relied on the Congressional decision in the Tax Reform Act of 1986 to reject proposals to tax MLPs as corporations, while limiting future conversions by existing corporations through the repeal of the General Utilities doctrine.

The history of the classification issue is known to the Subcommittee but because of our reliance on it, we find it necessary to summarize the history briefly below.

A. Senate Finance Committee Study. The story begins in 1983, when the Senate Finance Committee staff completed the first phase of a project to review the rules for corporate taxation. The staff report questioned why publicly traded limited partnerships should not be taxed as corporations. Hearings were held on October 24, 1983, at which time the Administration opposed any change in the current law regarding classification of partnerships. The subject of corporate tax reform was then dropped as attention turned to the legislation which became the Deficit Reduction Act of 1984. The final staff report of the Senate Finance Committee was issued in May 1985. It did not recommend taxation of any partnerships as corporations on the ground that the Treasury Department was studying the subject.

B. House Ways and Means Committee Study in 1983-1984 (H.R.4170). In the course of the House Ways and Means Committee's initial work on the Tax Reform Act of 1983 (H.R. 4170), an amendment was proposed for the taxation of publicly traded partnerships as corporations. However, this amendment was not considered at any length since H.R. 4170 did not reach the House floor in 1983. When consideration of H.R. 4170 was renewed in 1984, the Joint Committee staff proposed taxation of publicly traded partnerships for Ways and Means Committee consideration. Following the Ways and Means Committee hearings on H.R. 4170 in February 1984, the provision for taxing certain partnerships as corporations was dropped. Neither H.R. 4170 (as reported by the House) nor the Deficit Reduction Act of 1984 included any provision which changed the current taxation of publicly traded partnerships.

C. 1984 Treasury Study ("Treasury I"). In November, 1984, the Treasury Department issued its tax reform study entitled "Tax Reform for Fairness, Simplicity and Economic Growth" (which eventually became popularly known as "Treasury I"). This study proposed that all limited partnerships with more than 35 limited partners would be classified as associations. This proposal met with strong opposition, including opposition from many Congressmen and Senators and from ranking members of the Administration. Treasury I did not receive the President's backing.

D. . 1985 Treasury Study ("Treasury II"). In May 1985, with the President's support, the Treasury Department issued a revised tax reform study entitled "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (dubbed "Treasury II"). In Treasury II, the proposal for classifying limited partnerships with more than 35 limited partners as associations was dropped.

E. 1985 House Bill. In the summer of 1985, the staffs of the Joint Committee and the Ways and Means Committee prepared an alternative tax reform proposal to be used by the Ways and Means Committee for the mark up of a tax bill. Known as the "Rostenkowski Proposal", the House bill made loss pass-throughs a preference item but did not in any way suggest a change in the law regarding classification of limited partnerships. The House bill did contain a provision repealing the General Utilities doctrine. The House bill, H.R. 3838, was passed by the House on December 17, 1985.

F. 1986 Senate Finance Committee Action and Senate Bill. In early 1986, the staff of the Senate Finance Committee worked on a tax reform proposal for Committee Chairman Robert Packwood. In the final proposal, adopted by the Finance Committee on May 29, 1986, no reference was made to classifying any limited partnerships as associations. The matter had not been raised during the Finance Committee hearings on the bill and was not raised in the June floor debates on the bill in the full Senate. The Senate adopted the bill on June 24, 1986.

G. June 1986 Testimony by Assistant Secretary Mentz. On June 9, 1986, J. Roger Mentz, Treasury Department Assistant Secretary for Tax Policy, testified in hearings held by the Ways and Means Subcommittee on Select Revenue Measures on the taxation of pass-through entities. Mentz proposed that publicly traded limited partnerships be taxed as corporations.

H. Conference Action. The Conference Committee met from July 17 to August 16, 1986. It adopted the repeal of the General Utilities doctrine as proposed by the House. Once again there was no provision relating to partnership classification. In contrast to the proposal to tax MLPs as corporations, which was not incorporated in the Conference bill, various other proposals considered at the June Subcommittee hearings on the taxation of pass-through entities, including ones relating to regulated investment companies, real estate investment trusts, and the new real estate mortgage investment conduits, were in fact adopted and incorporated into the final bill. The Conference Report was filed on September 18, 1986 and both Houses and the President subsequently approved the bill.

Thus, the 1986 Act, which adopted the most sweeping changes to the Internal Revenue Code since 1954, did not change the taxation of MLPs.

ServiceMaster relied on this history in making its decision to change from corporate to partnership form in 1986. It reasonably concluded that Congress was satisfied with the existing set of rules which differentiated both publicly traded partnerships and non-traded partnerships from corporations. This was certainly not a case of Congress being unaware of the issue; committee staff reports and Treasury papers had repeatedly raised the issue in one form or another over the previous five years. Yet Congress consistently rejected the proposals, and thereby allowed companies like ServiceMaster to believe that a corporation-to-partnership conversion would not be undone in the foreseeable future, particularly in light of the repeal of the General Utilities doctrine.

Passive Losses and Debt Financing

Finally, the hearings invoked discussion of two further issues. (i) whether to classify income from publicly traded MLPs as portfolio income for purposes of the passive loss rules so that such income could not be sheltered by passive losses; and (ii) whether some limits should be imposed on the ability of MLPs to use debt financing.

ServiceMaster appreciates the reasons for a change in the passive loss rules that would treat income from publicly traded MLPs as portfolio income not shelterable with other passive losses and therefore would have no objection to legislation adopting such an approach.

ServiceMaster is concerned, however, about the impact of any rules limiting the use of debt financing on debt incurred by existing MLPs capitalized under current law. A focus on the debt to equity ratio of an MLP determined by reference to financial statements may exaggerate the extent to which the partnership actually uses debt financing. For example, the book equity of an MLP formed in a corporate liquidation is often computed for GAAP purposes using historic accounting cost rather than fair market value at the time of the liquidation or the tax basis of the assets reduced by liabilities. In either case, equity may be materially undervalued with the result that a misleadingly high debt to equity ratio is produced. Furthermore, since cash flow is critical to the way in which the market views MLPs, any new regulatory provisions should take cash flow characteristics into account.

ServiceMaster believes that if any rules on debt financing by MLPs are adopted, such rules should not apply to partnerships capitalized before the effective date of the legislation. In any case, such rules should be applied in a manner that reflects the fair market value of an MLP's equity and that recognizes the cash flow characteristics of the enterprise.

CONCLUSION

While ServiceMaster does not object to the proposed change in the passive loss rules, with respect to the basic question of how master limited partnerships should be classified for tax purposes, the fact is that ServiceMaster and its partners "played by the rules," paid the tax toll-charge for conversion to partnership form and its executives exposed themselves to personal liabilities. Accordingly, ServiceMaster deserves to retain its partnership classification, as a matter of fundamental fairness and principled tax policy.

C. William Pollard
President and Chief Executive Officer
ServiceMaster Limited Partnership

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